THE PETROLEUM INDUSTRY

HEARINGS

BEFORE THE

SUBCOMMITTEE ON ANTITRUST AND MONOPOLY

OF THE

COMMITTEE ON THE JUDICIARY UNITED STATES SENATE

NINETY-FOURTH CONGRESS

FIRST SESSION

ON

S. 2387 and Related Bills—S. 739, S. 745, S. 756, S. 1137, and S. 1138

VERTICAL INTEGRATION

PART 2

APPENDIX TO HEARINGS

SEPTEMBER 23, 26, OCTOBER 29, 31, NOVEMBER 12, AND 19, 1975

Printed for the use of the Committee on the Judiciary

(Pursuant to S. Res. 72, Sec. 4)

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U.S. GOVERNMENT PRINTING OFFICE

67-721 O WASHINGTON : 1976

For sale by the Superintendent of Documents, U.S. Government Printing Office
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Preface

The material reprinted here consists principally of a collection of documents from the public records of state tax cases in South Carolina and Wisconsin involving the Exxon Corporation. Both cases concern generally the method used by these states for calculating the taxable income of large corporations having different divisions and subsidiaries and doing business in several states. The central issue in the litigation is whether the different divisions and subsidiaries should be taxed separately under "segregated accounting" or should the income of the entire enterprise be taken together and apportioned out among the individual states according to a standard formula.

Under the laws of South Carolina and Wisconsin, the tax liability of a corporation depends upon whether its functional segments are deemed to be part of an interdependent, interrelated, "unitary" whole or, alternatively, its segments are considered to be functionally independent businesses which are unitary in their own right and are brought together under a corporate umbrella. A resolution of this central legal issue in the South Carolina and Wisconsin proceedings depends upon the nature of vertical integration in the petroleum industry: specifically, it hinges upon whether Exxon, a vertically integrated petroleum firm, is viewed as a single unitary operation or as a group of

unitary businesses collected under a corporate roof.

Because of the relevance of this issue to matters now before the Senate Subcommittee on Antitrust and Monopoly, the material is included in the hearing record on Vertical Integration in the Petroleum Industry. To the greatest extent possible, each document has been reprinted in its entirety. Some documents, however, such as the Exxon brief in the Wisconsin case, are quite lengthy and contain material unrelated to the vertical integration issue. Pages or parts of pages dealing with matters unrelated to petroleum industry structure (such as detailed discussion of tax statutes and auditing techniques used in examining Exxon's tax returns) have been omitted.

What has been attempted here is to reproduce accurately Exxon's analysis of its own corporate structure and the relationship each of its functional parts bears to one another as set forth in the company's testimony and presentations in state tax cases. In addition to the tax case documents, this volume contains a series of correspondence between the Subcommittee and Exxon regarding the Subcommittee's request for financial data about the company's functional units.

STATE OF SOUTH CAROLINA)
COUNTY OF RICHLAND) IN THE COURT OF COMMON PLEAS

Exxon Corporation,
Plaintiff,
-vs-
South Carolina Tax Commission,
Defendant.

COMPLAINT

Plaintiff alleges:

1. Plaintiff is a New Jersey corporation with its principal place of business in the State of New York. Plaintiff is successor to Humble Oil & Refining Company by merger effective January 1, 1973. Plaintiff is qualified to do business in South Carolina and is in good standing.

2. Defendant is a South Carolina state agency charged with assessment and collection of income taxes owing to the State of South Carolina.

3. Pursuant to S. C. Code §65-2661, on November 18, 1974, plaintiff made payment to defendant, under protest, of South Carolina income taxes for the calendar years 1970, 1971, and 1972 in the total amount of $1,490,855.00, plus interest thereon in the amount of $229,863.10, making a total payment of $1,720,718.10.

4. This action is brought pursuant to S. C. Code §65-2262 for recovery of such taxes and interest which were wrongfully and illegally collected.

5. The South Carolina income tax on a taxpayer which conducts its business partly within and partly without South Carolina is required to be "imposed upon a base which reasonably represents the proportion of the trade or business carried on within this State." S. C. Code §65-222.2. South Carolina does not impose a tax on such a taxpayer's entire net income, but only on the part of the income which is deemed to be earned in South Carolina. In order to determine how much of a taxpayer's income is earned in this state, South Carolina law specifically allocates certain parts of a taxpayer's total income to other states and does not include them as part of the taxpayer's income

which is subject to apportionment among the states. S. C. Code §§65-279.1, 65-279.2. After thus identifying the amount of the taxpayer's income which is subject to apportionment, South Carolina law provides that a certain fraction of the apportionable income shall be treated as income earned in South Carolina. The fraction used to apportion income is derived from the ratio of taxpayer's sales, property and payroll in South Carolina to its sales, property and payroll everywhere. S. C. Code §§65-279.3, et seq.

6. Defendant has incorrectly determined the amount of plaintiff's income which is subject to apportionment. Plaintiff does not challenge the fraction used to apportion part of this income to South Carolina.

7. Plaintiff is a multistate business corporation engaged in a number of functions in the United States, including

(a) exploration for oil and gas,

(b) production or extraction of oil and gas from the ground,

(c) refining of crude oil,

(d) marketing of petroleum products, and

(e) other functional operations.

Each of these functions is managed and accounted for on a functional operating basis. Each is a segment of plaintiff's total corporate enterprise, but each has its own accounting, budgeting and forecasting, its own management and staff, its own profit center, its own investment center, its own physical facilities, etc. The profit or loss of each function is separately and accurately computed.

8. Plaintiff's functional operations in South Carolina are confined to marketing and minor land management operations. All sales in South Carolina are made by plaintiff's marketing department; all properties owned by plaintiff in South Carolina are carried on the books of its marketing department; and all payrolls paid in South Carolina are paid by its marketing department. Plaintiff has absolutely no exploration, production, refining or other activities or properties in South Carolina.

9. Even though plaintiff's functional operations in South Carolina are confined to its marketing function and its minor land management operations, defendant has, by means of the application of the above-described apportionment formula to plaintiff's entire net income from all the above-described functional

operations in the United States, required plaintiff to pay South Carolina income taxes on a fractional portion thereof, this notwithstanding that a substantial portion of such income was earned or derived from operations carried on and properties situated outside South Carolina. Illegally included in such income base for South Carolina tax purposes were (a) situs income from the exploration and production function allocable to the states in which the properties and operations were situated and carried on, (b) situs income from other functional operations carried on from properties outside South Carolina, and (c) income from the refining function carried on from properties and operations outside the State.

10. This incorrect use of plaintiff entire United States net income as its income subject to apportionment has the effect of increasing the amount of plaintiff's income subject to tax in South Carolina for the three years involved here from approximately four million dollars to approximately twenty-nine million dollars. This 700% increase is attributable almost entirely to plaintiff's income from its exploration and production functions, none of which is conducted in South Carolina. Moreover, whereas percentage depletion is allowed by defendant in the determination of taxable income from oil and gas operations conducted in South Carolina, defendant, in the process of computing plaintiff's total net income for apportionment purposes, illegally permitted plaintiff only a cost depletion reduction for its out-of-state oil and gas production income, thereby increasing plaintiff's South Carolina tax by an amount in excess of $550,000.00 for the years in issue.

11. All of plaintiff's exploration and production income is subject to tax by the states in which this function is conducted. These production states include the income from exploration and production in those states in their respective tax bases. Thus plaintiff's exploration and production income is subject to double taxation as a result of defendant's wrongful inclusion of such income in plaintiff's taxable income, a fraction of which is taxed by South Carolina.

12. Defendant's method of assessing taxes against plaintiff is wrongful, arbitrary, capricious and illegal and is not in accordance with South Carolina income tax law, specifically §§65-222, 65-222.2, 65-259(8), 65-279.2,

and 65-279.1, and is not in conformance with defendant's own Rule I-R-23.

13. Plaintiff maintains books of account and records in such manner as to clearly reflect its true net income accruing or arising from sources within South Carolina and its true net income from sources without South Carolina. Defendant has arbitrarily, capriciously, and unlawfully denied plaintiff the right to file tax returns and calculate its tax based upon its net income arising from sources within South Carolina as determined by such books, as permitted by S. C. Code §65-279.11.

14. If defendant's method of computing plaintiff's taxable income is held to comply with S. C. Code §§65-222, 65-222.2, 65-259(8), 65-279.2 and 65-279.1, then one or more of said statutes, on its face or as applied to plaintiff, is in violation of the due process clause of the South Carolina Constitution, Article I, Section 5.

15. If defendant's method of computing plaintiff's taxable income is held to comply with S. C. Code §§65-222, 65-222.2, 65-259(8), 65-297.2 and 65-299.1, then one or more of said statutes, on its face or as applied to plaintiff, is in violation of the due process clause of the Fourteenth Amendment of the United States Constitution, and the commerce clause of Article I, Section 8(3) of the United States Constitution.

WHEREFORE, plaintiff prays for judgment against defendant in the amount of taxes of $1,490,855.00, plus interest thereon as provided by law, including interest of $229,863.10 to November 6, 1974, and for other appropriate relief as may be just and proper.

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December 12, 1974

STATE OF SOUTH CAROLINA)	IN THE COURT OF COMMON PLEAS
COUNTY OF RICHLAND)	

Exxon Corporation,)	
Plaintiff,)	
vs.)	DEFENDANT'S REQUEST FOR ADMISSION OF FACTS
South Carolina Tax Commission,)	
Defendant.)	

TO: Exxon Corporation

PURSUANT to Rule 89 of the Rules of Practice for the Circuit Courts of South Carolina, you are hereby requested to admit the truth of the facts set forth below:

1. On January 1, 1973, Humble Oil and Refining Company was merged into its parent corporation, Standard Oil Company of New Jersey. As a result of this merger, the company's name was changed to Exxon Corporation.

2. During the income tax years in question, i.e., calendar years ended December 31, 1970, 1971 and 1972, the plaintiff did business in this State in the form of Humble Oil and Refining Company using the trade name of Esso.

(HEREINAFTER ALL STATEMENTS FOR ADMISSIONS SHALL RELATE TO THE INCOME TAX YEARS IN ISSUE.)

3. The plaintiff was a multiphase oil company which was principally engaged in (1) exploration and production of crude oil, (2) the refining of crude oil, and (3) the marketing of petroleum products.

4. The plaintiff's corporate headquarters was located in Houston, Texas, where the executive officers assigned to and responsible for all major activities of the company were housed.

5. The organizational structure of the plaintiff's company was as follows:

(a) Board of Directors elected by its shareholders. The full Board of Directors appointed all officers of the company and set dividend policies.

(b) The Chairman of the Board implemented the policies and decisions of the Board of Directors and served the plaintiff as its principal spokesman with the public at large.

(c) The Executive Committee was delegated all operating powers possessed by the Board of Directors and operated in the absence of the Board.

(d) The Directors in Charge were composed of the executive officers of the company including the President and various Vice Presidents who were also Directors of the company. The Directors in Charge were responsible to the Board of Directors for The Operational Management Departments of the company and for the Coordination and Services Management Departments of the company.

5. The Coordination and Services Management Departments of the company consisted of thirteen (13) corporate staff departments with the responsibility of providing overall specialized corporate services for the company as a whole. These centralized staff services consisted of the following:

(a) Corporate Planning. It was responsible for the long-range planning of the company. It received information relative to the various overall company operations including exploration and production, refining and marketing, analyzed this information and reported to the Board of Directors. Its reports to the Board of Directors included advice on effectiveness of operations and suggestions for company strategy.

(b) Secretary. In addition to the usual corporate secretarial duties, this staff department had the responsibility for determining executive compensation and for executive training and development

throughout the company.

(c) Treasury. This department was headed by the Treasurer of the company who had responsibility for all financial resources of the company. The department developed financial policy and procedures including plans for the appropriate financing of the company's activities. This department maintained banking relationships and lines of credit for the company generally. It also provided analysis of proposed investments. Payments of expenses incurred throughout the company were paid by checks drawn on the Treasury of the company.

(d) Comptroller. This department was headed by the plaintiff's chief accountant. It was responsible for procedures and plans related to the appropriate systems of capital budgeting throughout the company and for providing appropriate systems for financial reporting and appropriate systems for financial forecasting. The department operated the computer centers of the company for which they maintained an accounting systems staff. The Comptroller Department maintained a system of internal control throughout the company at large and monitored this system through an internal audit staff which audited all phases of the plaintiff's business.

(e) The Department of General Services was responsible for providing office space and facilities for the entire company. It also supplied office services such as printing, reproduction and janitorial services.

(f) The Medical Department, in addition to providing advice to employees on a professional basis, was primarily concerned with industrial hygiene within the company.

(g) The Aviation Department operated and serviced the company aircraft which were available to executive personnel throughout the company when needed for the plaintiff's business.

(h) The Employee Relations Department was primarily responsible for providing a competent and able work force within the company. It developed plans and procedures for salaried administration and training. It sponsored employee development throughout the company. It had responsibility for employee benefit plans such as group life insurance, hospitalization insurance and savings plans. It gave specialized assistance on labor relation matters throughout the company. The Department assisted in moving employees from various positions throughout the company. This movement of employees was encouraged by the company and acted both as an incentive for the employees and as a pool from which the company could choose qualified and proven personnel. The Employee Relations Department was responsible for the administration of a company-wide pension plan and for company-wide profit sharing plans and stock option plans.

(i) The Tax Department was responsible for planning, coordination and administration of tax matters throughout the company. It was ultimately responsible for the accuracy of tax reporting to the federal government as well as to the various states in which the plaintiff did business. The Department gave tax advice throughout the company and represented the plaintiff before federal and state taxing bodies. It also assisted the company in tax oriented litigation.

(j) The Public Relations Department was responsible for the preservation of the company's good name and reputation with the public at large. It maintained communication and information services to the public through which it promoted an understanding of the company's overall character and its goals and performances. In recent years this Department has been especially concerned with informing the public of the company's concern with environmental protection and with its actions on behalf of environmental protection. The Public Relations

Department represented the plaintiff to the public as one company, a multiphase oil company, which is helpful to the public by providing good jobs and technological advancement.

(k) The Law Department, headed by the general counsel, provided legal counsel for the Board of Directors, the officers of the company and for various management groups throughout the company. It rendered assistance through giving advice and by drafting legal documents.

(l) The Government Relations Department coordinated the company's relations with the federal government. It represented the company before various committees of Congress and defended the company's policies and actions, particularly in the area of gasoline pricing.

(m) The Supply Department has company-wide responsibility in the area of transportation and distribution of the company's products, both crude and refined. The Supply Department transports crude oil from the company's wells to its refineries and from the refineries to the company's various distribution points. The Supply Department had the responsibility of providing crude for the plaintiff's refineries so that the refineries were kept, as near as possible, at full production.

(n) The Purchasing Department was a subdivision or activity of the Supply Department. It provided centralized purchasing for the company as a whole including operating functions of exploration and production, refining and also marketing.

6A. No fees or other charges were paid for corporate staff services furnished to any employees of the plaintiff, and these services were not offered to outside businesses.

6B. By reason of the volume of purchases made by the Supply Department, more favorable prices are obtained on automobile

accessories, i.e., tires, batteries, parts, which are marketed by the company.

7. The plaintiff has designated certain of its activities as "Operating Departments". The Operating Departments were:

(1) Marine
(2) Land Management
(3) Coal and Shale Oil
(4) Minerals
(5) Exploration and Production
(6) Refining
(7) Marketing

8. The Marine Department was headed by a general manager of the company who was not an officer. The Department was responsible for the profitable waterborne transportation of the company's petroleum products. It was responsible for the safe and efficient operation of waterborne equipment, ocean tankers and inland waterway equipment and operated the branch offices that were necessary for those vessels.

8A. The primary purpose of the Marine Department was to transport the company's crude oil to its refineries. It also transported refined petroleum products to processing plants where octane and other chemical balances were regulated. The company's tankers continuously used the port of Charleston, South Carolina.

9. The Land Management Department was also under the supervision of a general manager. This Department was primarily responsible for administering and disposing of surplus properties, mainly former service station sites where the company's petroleum products had been sold. During the years in question, this Department administered and sold numerous service station sites located in South Carolina.

10. The Coal and Shale Oil Department and the Minerals Department were each headed by a general manager. The Coal and Shale Oil Department was responsible for locating and acquiring hydrocarbon

deposits and for conducting all operations incident to the mining of those deposits. The Minerals Department was responsible for the exploration and discovery of non-hydrocarbon mineral deposits and for this extraction. These Departments did not operate in South Carolina. The company had no coal, shale or other mineral deposits in this State.

11. The company has designated its three (3) major operating activities as follows:

(1) The Exploration and Production Department
(2) The Refining Department
(3) The Marketing Department

12. Each of these Departments was under the supervision of a Vice President of the company who was headquartered in Houston.

13. The company has established an accounting system for each of the three aforementioned operating departments.

14. The company has always followed a policy of independent responsibility for the management of the three departments. The basis of this policy is that independent responsibility for each of the three major departments is one of the most effective management tools for measuring for performance of the departments and for improving their operations.

15. Under the aforementioned plan, the three departments compete with one another, not only to show department profitability, but also for available company funds for investment in the activities designated by the company as belonging to these divisions.

16. Another advantage to the company of independent responsibility was to hold the management of each department to a stewardship for the operation of any company properties which were managed by that division.

17. Plaintiff is a multiphase oil company engaged in exploration and production, refining and also marketing of petroleum products.

This type of company is often referred to as a vertically integrated oil business.

18. A number of benefits inure to a vertically integrated oil company which are not available to an oil company engaged in a single phase of the oil business such as a company engaged in only marketing. Those benefits are:

(a) The petroleum industry is a highly capital-intensive business with high fixed operating costs as compared to total operating costs, therefore, profitability in this industry is very sensitive to full rates of capacity utilization. In other words, the existence of exploration and production facilities helps insure a supply of crude oil to the plaintiff's refineries, and the ownership of refineries helps insure that the crude from exploration and production will be refined.

(b) The fact that the plaintiff is engaged in extensive marketing provides a stable outlet for its refined products.

(c) The plaintiff's multiphase nature provides greater profit stability because nonparallel and nonmutual economic factors which affect one phase may be offset by similar factors in another department.

(d) Diversity inherent in a multiphase oil company decreases economic risk. The exploration and production department has, by its nature, a very high degree of risk. When this activity is combined with refining and marketing, it provides a diversification and gives protection to the exploration and production activities.

(e) The plaintiff's multiphase nature permits utilization of corporate staff services of high quality and with maximum economy.

19. The plaintiff had surplus refining of crude oil.

20. More than three-fourths of the petroleum products marketed by the company came from its refineries.

21. The company, in order to supply its refineries, acquired

crude oil over and above the crude that was produced by its exploration and production activities.

22. The volume of crude oil produced by the plaintiff's Exploration and Production Department was equal to more than half of the volume of crude oil refined in its refineries.

23. Nearly all of the plaintiff's petroleum products sold in South Carolina came from its refineries.

24. Of the plaintiff's refined petroleum products that were sold in this State, over one-fourth originated as crude oil produced by the company's exploration and production activities.

25. Of the plaintiff's refined petroleum products that were sold in this State, over one-third originated as crude oil produced by the company's exploration and production activities.

26. Of the plaintiff's refined petroleum products that were sold in this State, over one-half originated as crude oil produced by the company's exploration and production activities.

27. Of the plaintiff's refined petroleum products that were sold in this State, over two-thirds originated as crude oil produced by the company's exploration and production activities.

28. That of the plaintiff's refined petroleum products that were sold in this State, over one-fourth either originated as crude oil produced by the company's exploration and production activities or originated as crude oil produced by another company and made available to the plaintiff because of the existence of crude oil produced by the plaintiff's production activities, e.g., another company's crude obtained by exchange of the plaintiff's crude.

29. That of the plaintiff's refined petroleum products that were sold in this State, over one-third either originated as crude oil produced by the company's exploration and production activities or

originated as crude oil produced by another company and made available to the plaintiff because of the existence of crude oil produced by the plaintiff's production activities, e.g., another company's crude obtained by exchange of the plaintiff's crude.

30. That of the plaintiff's refined petroleum products that were sold in this State, over one-half either originated as crude oil produced by the company's exploration and production activities or originated as crude oil produced by another company and made available to the plaintiff because of the existence of crude oil produced by the plaintiff's production activities, e.g., another company's crude obtained by exchange of the plaintiff's crude.

31. That of the plaintiff's refined petroleum products that were sold in this State, over two-thirds either originated as crude oil produced by the company's exploration and production activities or originated as crude oil produced by another company and made available to the plaintiff because of the existence of crude oil produced by the plaintiff's production activities, e.g., another company's crude obtained by exchange of the plaintiff's crude.

32. The plaintiff's corporate headquarters in Houston, Texas, was housed in a forty-four (44) story office building. Approximately 3,000 employees worked there.

33. All operating management of the company, i.e., Vice Presidents of Exploration and Production, Refining and also Marketing, as well as their staffs, were headquartered in Houston.

34. The plaintiff's marketing activities in forty-seven (47) states were controlled from Houston. These activities included:

(a) centralized advertising
(b) uniform credit card system generally administered from Houston with accounting and collection activities carried on through three credit card centers.

35. The plaintiff's refining activities and manufacturing plants

were located at Everett, Mass.; Bayonne, N.J.; Bayway, N.J.; Pittsburgh, Penn.; Baltimore, Md.; Baton Rouge, La.; Baytown, Tex.; Billings, Mont.; Benicia, Calif. and Charleston, S. C.

36. Motor oils, greases and other packaged products were manufactured by the plaintiff from raw materials which included its own produced crude oil at its refineries and manufacturing plants in Baytown, Texas; Bayway, New Jersey and Baton Rouge, Louisiana. These products were sold by the company in South Carolina.

37. The plaintiff has operated in South Carolina and in other states on the eastern seaboard under the name of Esso for more than thirty (30) years.

38. The company used uniformly designed and constructed service stations in order to promote the sale of its branded gasoline.

39. The plaintiff was a company wide self-insurer covering risks up to Ten Million Dollars. Through self insurance, the company made substantial savings on insurance costs.

40. The plaintiff operated a plant at Charleston, South Carolina.

41. The Charleston plant was one of the company's major installations covering approximately 190 acres of land.

42. Petroleum products were processed at the Charleston plant, not only for distribution in this State, but for distribution in a number of neighboring states.

43. The Charleston plant was engaged in both refining crude oil and in processing refined petroleum products.

44. The plaintiff has never requested permission from or attempted to obtain the approval of the South Carolina Tax Commission to compute its income based on books or records relating to activities or sources of income from within this State.

This request is made in good faith, the subject hereof is

genuinely relevant to this case, and evidence of the subject hereof is necessary to the establishment of my client's defense.

Daniel R. McLeod

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Columbia, South Carolina
September 29, 1975

67-721 1190

STATE OF SOUTH CAROLINA)
COUNTY OF RICHLAND)
IN THE COURT OF COMMON PLEAS

Exxon Corporation,
Plaintiff,
vs.
South Carolina Tax Commission,
Defendant.

PLAINTIFF'S ANSWERS TO DEFENDANT'S REQUEST FOR ADMISSION OF FACTS

TO: South Carolina Tax Commission

Plaintiff, Exxon Corporation, answers the defendant's request for admission of facts as follows:

As the taxpayer for the years in question, 1970, 1971 and 1972 was Humble Oil & Refining Company, all answers to this request are made for Humble Oil & Refining Company unless otherwise indicated.

REQUEST NO. 1.

ANSWER:

Plaintiff denies the truth of this request as phrased. Plaintiff admits that: On November 1, 1972, Humble Oil & Refining Company's parent corporation, Standard Oil Company (a New Jersey corporation), changed its name to Exxon Corporation. On January 1, 1973, Humble Oil & Refining Company was merged into its parent corporation and its operations have since been carried on as Exxon Company, U.S.A., a division of Exxon Corporation.

REQUEST NO. 2.

ANSWER:

Plaintiff admits the truth of the matters set forth in this request, except that the correct name is Humble Oil & Refining Company.

REQUEST NO. 3.

ANSWER:

Plaintiff denies the truth of this request as phrased. Plaintiff admits that: Plaintiff was a company which was engaged in a number of separate functional operations the principal ones of which were the exploration and production of crude oil and gas, the refining of crude oil and the marketing of petroleum products.

REQUEST NO. 4.

ANSWER:

Plaintiff admits the truth of the matters set forth in this request.

REQUEST NO. 5.

ANSWER:

Plaintiff admits the truth of the matters set forth in this request, except that plaintiff's Board of Directors was elected by the sole shareholder of the company since the company only had one shareholder.

REQUEST NO. 6.

ANSWER:

Plaintiff admits the truth of the matters set forth in this request, except that for the years in question there were twelve (12) corporate staff departments.

REQUEST NO. 6(a).

ANSWER:

Plaintiff admits the truth of the matters set forth in this request.

REQUEST NO. 6(b).

ANSWER:

Plaintiff admits the truth of the matters set forth in this request.

REQUEST NO. 6(c).

ANSWER:

Plaintiff admits the truth of the matters set forth in the first three sentences of this request. However, plaintiff denies the truth of the matters set forth in the fourth and fifth sentences of this request which read as follows:

> "It also provided analysis of proposed investments. Payments of expenses incurred throughout the company were paid by checks drawn on the Treasury of the company."

REQUEST NO. 6(d).

ANSWER:

Plaintiff denies the truth of this request as phrased. Plaintiff admits that: Controller's. This department was responsible for procedures and plans relating to the appropriate systems of capital budgeting throughout the company and for providing appropriate systems for financial reporting and appropriate systems for financial forecasting. The department operated some of the computer centers of the company for which they maintained an accounting systems staff. The Controller's Department maintained a system of internal control throughout the company at large and monitored this system through an internal audit staff which audited all phases of the plaintiff's business.

REQUEST NO. 6(e).

ANSWER:

Plaintiff admits the truth of the matters set forth in this request.

REQUEST NO. 6(f).

ANSWER:

Plaintiff admits the truth of the matters set forth in this request.

REQUEST NO. 6(g).

ANSWER:

Plaintiff admits the truth of the matters set forth in this request.

REQUEST NO. 6(h).

ANSWER:

Plaintiff admits the truth of the matters set forth in this request, except that plaintiff denies the truth of the matters set forth in the sentence which reads as follows: "This movement of employees was encouraged by the company and acted both as an incentive for the employees and as a pool from which the company could choose qualified and proven personne

REQUEST NO. 6(i).

ANSWER:

Plaintiff admits the truth of the matters set forth in this request.

REQUEST NO. 6(j).

ANSWER:

Plaintiff denies the truth of the matters set forth in this request. Plaintiff admits that: During the years in issue plaintiff did not have a Public Relations Department or a Government Relations Department. These two departments were combined in the Public Affairs Department. The Public Affairs Department was responsible for the identification and evaluation of governmental, political, public, social and other environmental factors presenting long or short range constraints on or opportunities for the company in the achievement of its goals and objectives. It was responsible for the development and implementation of company public affairs goals and objectives and such plans, policies, and strategies as were necessary to achieve these goals and objectives.

REQUEST NO. 6(k).

ANSWER:

Plaintiff admits the truth of the matters set forth in this request.

REQUEST NO. 6(l).

ANSWER:

See the answer to Request No. 6(j).

REQUEST NO. 6(m).

ANSWER:

Plaintiff admits that the Supply Department had the responsibility for providing crude for the plaintiff's refineries Plaintiff denies the truth of the remaining matters set forth in this request.

REQUEST NO. 6(n).

ANSWER:

Plaintiff denies the truth of the matters set forth in this request. Plaintiff admits that the Supply Department did some company purchasing.

REQUEST NO. 6A.

ANSWER:

Plaintiff cannot truthfully admit or deny the matters set forth in this request because the request as phrased is ambiguous and cannot be understood. Therefore, it is impossible to answer this request.

REQUEST NO. 6B.

ANSWER:

Plaintiff denies the truth of the matters set forth in this request.

REQUEST NO. 7.

ANSWER:

Plaintiff denies the truth of this request as phrased. Plaintiff admits that plaintiff has a number of separate

functional operating departments identified as follows:

(1) Marine
(2) Land Management
(3) Minerals
(4) Exploration and Production
(5) Refining
(6) Marketing

REQUEST NO. 8.

ANSWER:

Plaintiff admits the truth of the matters set forth in this request.

REQUEST NO. 8A.

ANSWER:

Plaintiff denies the truth of this request as phrased. Plaintiff admits that: The primary responsibility of the Marine Department was the waterborne transportation of the company's crude oil and refined petroleum products. The company' tankers continuously used the Port of Charleston, South Carolina.

REQUEST NO. 9.

ANSWER:

Plaintiff admits the truth of the matters set forth in the first two sentences of this request. Plaintiff denies the truth of the matters set forth in the third sentence of this request. Plaintiff admits that: During the years in question, this department administered and sold surplus service station sites located in South Carolina.

REQUEST NO. 10.

ANSWER:

Plaintiff denies the truth of this request as phrased. Plaintiff admits that: The Minerals Department was headed by a General Manager. The Minerals Department was responsible for the exploration and discovery of non-hydrocarbon mineral deposits

and for their extraction. This department did not operate in South Carolina. The company had no coal, shale or other mineral deposits in South Carolina.

REQUEST NO. 11

ANSWER:

Plaintiff denies the truth of this request as phrased. Plaintiff admits that: Plaintiff has three principal functional operating departments identified as follows: (1) exploration and production department; (2) refining department; and (3) marketing department.

REQUEST NO. 12.

ANSWER:

Plaintiff admits the truth of the matters set forth in this request.

REQUEST NO. 13.

ANSWER:

Plaintiff admits the truth of the matters set forth in this request, in addition, plaintiff admits that each operating department's accounting system is designed to accommodate its separate needs.

REQUEST NO. 14.

ANSWER:

Plaintiff admits the truth of the matters set forth in this request.

REQUEST NO. 15.

ANSWER:

Plaintiff denies the truth of this request as phrased. Plaintiff admits that: Under the aforementioned policy the three departments compete with one another, not only to show department profitability, but also for available company funds for investment in the activities of the separate functional operations.

REQUEST NO. 16.

ANSWER:

Plaintiff admits the truth of the matters set forth in this request.

REQUEST NO. 17.

ANSWER:

Plaintiff denies the truth of this request as phrased. Plaintiff admits that: Plaintiff is a company engaged in exploration and production, refining and also marketing of petroleum products. This type of company is often referred to as a vertically integrated oil business.

REQUEST NO. 18.

ANSWER:

Plaintiff denies the truth of this request as phrased. Plaintiff admits that: There are a number of reasons why the plaintiff's separate functional operating departments are combined under one corporate entity. Some of these reasons are:

REQUEST NO. 18(a).

ANSWER:

Plaintiff denies the truth of this request as phrased. Plaintiff admits that: The petroleum industry is highly capital-intensive having high fixed operating costs relative to total operating costs so that profitability of such an industry is very sensitive to full rates of capacity utilization. The combination of exploration and production with refining and marketing under a single corporate entity provides some assurance of crude supplies and product outlet so that the risk of disruptions in refining operations due to supply and demand inbalances is minimized.

REQUEST NO. 18(b).

ANSWER:

Plaintiff denies the truth of this request as phrased. See the answer to Request No. 18(a).

REQUEST NO. 18(c).

ANSWER:

Plaintiff denies the truth of this request as phrased. Plaintiff admits that: The placing of individual segments under one corporate entity, as in the plaintiff's case, provides greater profit stability because non-parallel and non-mutual economic factors which may affect one department may be offset by factors existing in another department.

REQUEST NO. 18(d).

ANSWER:

Plaintiff denies the truth of this request as phrased. Plaintiff admits that: The combination of the individual segments under one corporate entity decreases economic risk. The operations of the exploration and production department have a very high degree of risk. When this activity is combined with other operations with less risk, such as refining and marketing, it provides a diversification and gives some protection against the risk hazard.

REQUEST NO. 18(e).

ANSWER:

Plaintiff denies the truth of this request as phrased. Plaintiff admits that: The combination of the individual segments under one corporate entity permits utilization of corporate staff services of high quality with greater economy.

REQUEST NO. 19.

ANSWER:

Plaintiff cannot truthfully admit or deny the matters set forth in this request because the request is ambiguous and as phrased it cannot be answered.

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REQUEST NO. 20.

ANSWER:

Plaintiff cannot truthfully admit or deny the matters set forth in this request. The records maintained by plaintiff are insufficient to provide an answer to this request.

REQUEST NO. 21.

ANSWER:

Plaintiff denies the truth of this request as phrased. Plaintiff admits that: Plaintiff bought crude oil from third parties in order to supply its refineries.

REQUEST NO. 22.

ANSWER:

Plaintiff admits the truth of the matters set forth in this request.

REQUEST NO. 23.

ANSWER:

Plaintiff denies the truth of this request as phrased. Plaintiff admits that: Some of the plaintiff's petroleum products sold in South Carolina came from its refineries.

REUQEST NO. 24.

ANSWER:

Plaintiff cannot truthfully admit or deny the matters set forth in this request for the reason that as the proof in this cause will show due to the commingling of crude oil it is not possible for plaintiff to answer this request.

REQUEST NO. 25.

ANSWER:

Plaintiff cannot truthfully admit or deny the matters set forth in this request for the reason that as the proof in this cause will show due to the commingling of crude oil it is not possible for plaintiff to answer this request.

REQUEST NO. 26.

ANSWER:

.Plaintiff cannot truthfully admit or deny the matters set forth in this request for the reason that as the proof in this cause will show due to the commingling of crude oil it is not possible for plaintiff to answer this request.

REQUEST NO. 27.

ANSWER:

Plaintiff cannot truthfully admit or deny the matters set forth in this request for the reason that as the proof in this cause will show due to the commingling of crude oil it is not possible for plaintiff to answer this request.

REQUEST NO. 28.

ANSWER:

Plaintiff cannot truthfully admit or deny the matters set forth in this request for the reason that as the proof in this cause will show due to the commingling of crude oil it is not possible for plaintiff to answer this request.

REQUEST NO. 29.

ANSWER:

Plaintiff cannot truthfully admit or deny the matters set forth in this request for the reason that as the proof in this cause will show due to the commingling of crude oil it is not possible for plaintiff to answer this request.

REQUEST NO. 30.

ANSWER:

Plaintiff cannot truthfully admit or deny the matters set forth in this request for the reason that as the proof in this cause will show due to the commingling of crude oil it is not possible for plaintiff to answer this request.

REQUEST NO. 31.

ANSWER:

Plaintiff cannot truthfully admit or deny the matters set forth in this request for the reason that as the proof in this cause will show due to the commingling of crude oil it is not possible for plaintiff to answer this request.

REQUEST NO. 32.

ANSWER:

Plaintiff admits the truth of the matters set forth in this request.

REQUEST NO. 33.

ANSWER:

Plaintiff denies the truth of this request as phrased. Plaintiff admits that: The executive management of the functional operating departments of Exploration and Production, Refining and Marketing, i.e., Vice Presidents and their immediate executive staffs, were headquartered in Houston.

REQUEST NO. 34.

ANSWER:

Plaintiff denies the truth of the matters set forth in this request.

REQUEST NO. 35.

ANSWER:

Plaintiff denies the truth of this request as phrased. Plaintiff admits that: The plaintiff's Refining Department had refineries located at Bayonne, New Jersey; Bayway, New Jersey; Baton Rouge, Louisiana; Baytown, Texas; Billings, Montana and Benicia, California. The plaintiff's Refining Department also had a manufacturing plant at Pittsburgh, Pennsylvania. Plaintiff' Marketing Department operated the Charleston, South Carolina terminal which included a hot asphalt sales facility, a product blending operation and a motor oil canning facility all of which were part of plaintiff's marketing organization.

REQUEST NO. 36.

ANSWER:

Plaintiff denies the truth of this request as phrased. Plaintiff admits that: Some motor oils, greases and other packaged products were manufactured by the plaintiff from raw materials some of which included some of its own produced crude oil at its refineries and manufacturing plants in Baytown, Texas; Bayway, New Jersey and Baton Rouge, Louisiana. Some of these products were sold by the company in South Carolina.

REQUEST NO. 37.

ANSWER:

Plaintiff denies the truth of this request as phrased. Plaintiff admits that: The plaintiff or its predecessors have operated in South Carolina and in certain other states on the eastern seaboard under the name of Esso for more than thirty (30) years.

REQUEST NO. 38.

ANSWER:

Plaintiff denies the truth of this request as phrased. Plaintiff admits that: In many cases plaintiff used uniformly designed and constructed service stations in order to promote the sale of its branded gasoline.

REQUEST NO. 39.

ANSWER:

Plaintiff denies the truth of this request as phrased. Plaintiff admits that: The plaintiff was a company wide self-insurer covering property risks up to ten million dollars. Through self insurance, the company made savings on insurance costs.

REQUEST NO. 40.

ANSWER:

Plaintiff denies the truth of the matters set forth in this request. See the answer to Request No. 35.

REQUEST NO. 41.

ANSWER:

Plaintiff denies the truth of the matters set forth in this request. See the answer to Request No. 35.

REQUEST NO. 42.

ANSWER:

Plaintiff denies the truth of this request as phrased. For a description of the activities of the Charleston facility see the answer to Request No. 35. Plaintiff admits that: Some of the products from the Charleston facility were distributed in some of the neighboring states.

REQUEST NO. 43.

ANSWER:

Plaintiff denies the truth of the matters set forth in this request.

REQUEST NO. 44.

ANSWER:

Plaintiff denies the truth of the request as phrased. Plaintiff admits that: The plaintiff has never expressly requested permission from or has expressly attempted to obtain the approval of the South Carolina Tax Commission to compute its income based on separate accounting on a South Carolina georgraphic basis.

BOYD, KNOWLTON, TATE & FINLAY

By Charles W. Knowlton

By

Twelfth Floor SCN Center
Corner Lady and Main Street
Columbia, S.C. 29201

McBRIDE, BAKER, WIENKE & SCHLOSSER

By

STATE OF TEXAS)
) SS
COUNTY OF HARRIS)

VERIFICATION

Personally appeared before me W. Trent Turpin, who is the Vice President of Exxon Corporation, the plaintiff herein, and who is duly authorized to make this verification, and who being duly sworn, deposes and says that he has read the attached Plaintiff's Answers To Defendant's Request For Admission Of Facts and that the matters stated therein are true as to those matters of which he has personal knowledge, and as to those matters based on information and belief, he believes them to be true.

W. Trent Turpin

SWORN to before me this 12th day of November, 1975.

Gracie B. McDowell (L.S.)
Notary Public for Texas

GRACIE B. McDOWELL
Notary Public in and for Harris County, Texas
My Commission Expires: 6/1/77

STATE OF WISCONSIN

WISCONSIN TAX APPEALS COMMISSION

* *

EXXON CORPORATION, (f/k/a Humble Oil and Refining Company),

Petitioner,

- vs -

Docket No. I-3806

WISCONSIN DEPARTMENT OF REVENUE,

Respondent.

* *

TRANSCRIPT OF PROCEEDINGS in the above-entitled matter held before the Wisconsin Tax Appeals Commission, in Room 229, City-County Building, Madison, Wisconsin, on the 2nd day of October, 1974, commencing at 10:25 in the forenoon.

PRESIDING: R. J. SMRZ, Chairman
THOMAS R. TIMKEN, Member
JOHN P. MORRIS, Member

ALSO PRESENT: JAY C. GITCHELL, Hearing Examiner

A P P E A R A N C E S

BOARDMAN, SUHR, CURRY & FIELD, Attorneys at Law, 131 West Wilson Street, Madison, Wisconsin, by THOMAS G. RAGATZ,

and

McBRIDE, BAKER, WIENKE & SCHLOSSER, Attorneys at Law, 110 North Wacker Drive, Chicago, Illinois, by LLOYD M. McBRIDE and PAUL D. FRENZ,

and

ROBERT E. TANNEHILL, Tax Attorney, Exxon Company, Houston, Texas, appearing on behalf of Petitioner.

IRVING F. SHAPIRO and ROBERT M. FINLEY, Tax Counsel, Wisconsin Department of Revenue, 201 East Washington Avenue, Madison, Wisconsin, appearing on behalf of Respondent.

MR. TIMKEN: We will call for a hearing in the matter of Exxon Corporation, Petitioner, versus Wisconsin Department of Revenue, Respondent, Docket I-3806.

Will you give the appearances, please?

MR. RAGATZ: For the petitioner, Attorney Thomas G. Ragatz of Boardman, Suhr, Curry and Field in Madison. Also appearing for the petitioner are Attorneys Lloyd McBride and Paul Frenz of McBride, Baker, Wienke & Schlosser from Chicago, and Attorney Robert Tannehill of Exxon, Houston, Texas.

MR. SHAPIRO: For the respondent, Irving F. Shapiro and Robert M. Finley.

MR. TIMKEN: You may proceed, Mr. Shapiro. Mr. Ragatz, do we have a corporate officer present or has that been waived?

MR. RAGATZ: I believe at pretrial I advised the Commission and the counsel for the Department that we would have a corporate officer here tomorrow, and counsel for the Department indicated that they would not object to that procedure. He will be here to testify and he will be available

for cross-examination.

MR. TIMKEN: Very well. Mr. Shapiro, you may proceed.

MR. SHAPIRO: Sir, the usual practice of the Commission is to have the respondent offer the so-called jurisdictional exhibits at this time, and following that the petitioner proceeds with its case. Since the jurisdictional exhibits have been incorporated into the documentsthat have been stipulated to, I am requesting -- and the stipulation has been entered into the record as Exhibit 15, I am wondering whether it is appropriate for the respondent to proceed any further at this time.

MR. TIMKEN: Mr. Ragatz, would you like to proceed?

MR. RAGATZ: As counsel for respondent has indicated, we have stipulated to the admission of, I believe it is now 15 categories of documents, one category having about another 15 sub-numbers, so there are approximately 30 documents that are already stipulated in, well, many more

documents because there are working papers and very numerous documents in there and they are entered as one exhibit.

It might be worthwhile for us to read in at least the factual parts of the stipulation at this time before I proceed with the opening statement just to give you a little factual background and to accomplish what we hope would be a saving of time by preparing this stipulation.

I may say initially that the documents we have stipulated into evidence per the stipulation shall be stipulated into evidence in this action and made part of the record for purposes of all hearings, trials and appeals in this cause, to provide undisputed evidence of the authenticity, existence and contents of such documents with the reservation that each party reserves the right to argue the relevance of any data contained in the documents, and I am assuming such arguments would be made in brief after the hearing and would not take up the time now.

As I say, we have enumerated roughly 30 documents, and pursuant to the stipulation I would like to move the admission of these documents set forth in the stipulation and the stipulation itself into evidence at this time to be formally made part of the record.

MR. TIMKEN: Do we have that stipulation before us? Mr. Shapiro, any objection?

MR. SHAPIRO: No objection.

MR. TIMKEN: Very well, the stipulation is accepted and the exhibits contained therein are accepted and received into the record.

MR. RAGATZ: In connection with the stipulation I would further note that the exhibits numbered 7, 8, 9 and 10 constitute the discovery transcripts of four employees of the Department of Revenue, and you will recall that the Commission granted the petitioner discovery authority and that we took these depositions back in January. Now to save time at this proceeding, we have agreed with counsel for the Department

of Revenue that these discovery transcripts would be as exhibits and part of the record and that the testimony given therein is part of the record for purposes of this case.

Now because of this we can avoid covering a lot of ground the second time. However, for the Commission to get the full understanding of the evidence, you will have to examine those exhibits, and we will highlight at least some of that testimony to try to give you continuity to the picture as we present the case.

Now I would like to read for the record the facts that have been stipulated and the basis of this stipulation is that counsel have agreed for purposes of this action only to the truth of the following facts and to the admissibility of this stipulation into evidence in this action for use in all the hearings, trials and appeals in this case, for the purpose of providing undisputed evidence of such facts.

(1.) Petitioner timely filed its Wisconsin corporation income and franchise tax returns for the calendar tax years of 1965 to 1968, both inclusive. The returns were prepared and the computations made on the separate accounting method. Losses were shown in the amounts of $821,320; $1,159,830; $1,026,224; and $919,575, respectively, for the years 1965, 1966, 1967 and 1968, aggregating $3,926,949 for the four year period. No tax was shown as being due for any such year.

(2.) Under date of June 25, 1971, C. J. Hoel, Section Chief of the Respondent, forwarded to Petitioner a Notice of Assessment of Additional Income and Franchise Tax (Exhibit 1), to which there was appended the Franchise Tax Audit Report (the "Audit Report") of Mr. Thomas J. Sheridan dated May 1, 1971, in which he found that Petitioner's income was subject to apportionment, which subjected it to tax on or measured by additional income of $4,532,155 for the period 1965 through 1968. Additional taxes in the amount of $316,470.85 were

thereby assessed against Petitioner. These documents were received by Petitioner on June 28, 1971.

(3.) Under date of July 21, 1971, Petitioner timely filed an Application for Abatement (Exhibit 3). On October 26, 1971, an informal conference was held on the Application in the offices of the Respondent at Madison, Wisconsin.

(4.) Under date of November 30, 1971, C. J. Hoel, forwarded to Petitioner a Notice of Denial of Application for Abatement (Exhibit 4), to which there was appended a Notice of Additional Taxes Due, dated November 30, 1971, in the principal amount of $316,470.85, plus interest.

(5.) On December 30, 1971, Petitioner timely filed a Petition for Review by the Commission (Exhibit 5), and subsequently Respondent timely served and filed its Answer (Exhibit 6).

(6.) Petitioner subsequently made an application for discovery authorization, which the Commission granted on May 26, 1973;

and the discovery examinations of four employees of the Respondent were conducted on January 15 and 16, 1974 and the transcripts of such examinations were Exhibits 7 through 10 herein. Pursuant to a Subpoena Duces Tecum served upon Respondent by stipulation with its counsel, Respondent produced the documents sub-numbered under Exhibit 11 herein and others, indicating that such documents constitute all documents known to Respondent covered by the enumerated categories in the Subpoena and pertinent to the audit and assessment of the Petitioner for the 1965-1968 period of the audit in issue and for the 1960-1964 period of the prior audit, with the exception of documents referred to as the "Continental Oil Co. work papers" which were used as a model for the audit of the Petitioner but which Respondent refused to produce and which refusal was upheld by the Commission.

(7.) Respondent had also audited the Petitioner for the period 1960 through 1964, which audit was conducted for Respondent by

Kurt Kaspar, Jr. The Notice of Assessment and Audit Report for that period is Exhibit 2 herein.

(8.) Petitioner Exxon Corporation (hereinafter "Exxon") was formerly named Standard Oil Company of New Jersey (hereinafter "SONJ") which prior to the name change in early 1973 was the owner of a wholly owned subsidiary corporation named Humble Oil & Refining Company (hereinafter referred to as "Humble"). At about the time of the name change Humble was merged into Exxon, making Exxon the legal successor to the original Petitioner in this action.

(9.) In 1956 SONJ organized as a wholly owned subsidiary a Delaware corporation named Pate Oil Company, which then acquired all of the assets and liabilities of Saxon Corporation, a Wisconsin corporation whose name had just been changed from Pate Oil Company. The new Pate Oil Company continued the operations of the former company under the name "Pate," which operations were all located in Wisconsin and consisted of the marketing of petroleum products and accessory

products. Corporate income tax reporting to the State of Wisconsin was done on the basis of the results of the new corporation's Wisconsin marketing operations, which continued the pattern of the former Pate corporation in reporting all of its income to Wisconsin.

(10.) On June 30, 1960 SONJ caused (new) Pate to be merged into Humble, and thereafter the Wisconsin marketing operations were continued by Humble with the brand name being changed to "Enco." In early 1973 Humble was merged into SONJ and the latter's name changed to Exxon. Petitioner will be referred to in this case as either "Exxon" or "Humble," and such references are intended, unless otherwise specified, to refer to the legal entity which conducted the Wisconsin operations, named Humble Oil & Refining Company, to which Exxon is now the legal successor.

That concludes the stipulation. And now, unless you would like something different, I will proceed with the opening statement.

MR. TIMKEN: You may proceed.

MR. RAGATZ: May it please the Commission: we are here today to present the case of petitioner, Exxon Corporation, in connection with its petition requesting reversal of the Wisconsin Department of Revenue's denial of an application for abatement of corporate franchise taxes assessed for the years 1965 through 1968.

Initially, I would like to point out as the stipulation already does that the name of the petitioner during the years in issue was Humble Oil and Refining Company and that we will undoubtedly, through our witnesses, be referring to the petitioner on occasion by Exxon, but most of the time by the name of Humble. But these are one and the same entity in that Exxon is the legal successor by merger to Humble.

And, incidentally, one of the jurisdictional exhibits relating to the petition is an amendment to the original petition changing the name from Humble to Exxon.

Now during the years in issue Humble

was engaged in the major domestic operations of exploring for, producing, refining, transporting and marketing oil and gas and related petroleum products. Because of legal reasons it operated these service stations all over the country under various names. In Wisconsin the brand name used was "Enco" and in fact that same brand name is still in use here in Wisconsin today despite the fact that the Exxon brand name has been implemented elsewhere.

For reasons related to the facts here in issue, Exxon has not seen fit to change the name of its Wisconsin operations. One of the witnesses will elaborate on this further.

The evidence will show that Humble was organized on a functionally independent basis, and that its separate functions were operated as separate businesses in competition with other oil companies ~~have~~ having similar functions and other companies which only operated in the business activity of a particular function.

We intend to develop through the evidence the functional independence of the various departments, and we ask the Commission to pay particular attention to this aspect of the case.

The key functional departments which will be discussed in evidence are Exploration and Production, frequently referred to as E and P, the refining function and the marketing function. Now while there are other functional departments such as marine, land management, minerals and coal and shale oil, the results of the operations by these departments are largely situs oriented and although respondent included them for the most part in apportionable income on its audit, we believe that at least since the discovery examination it should recognize that the income of such functional departments is properly allocable to situs.

For purposes of this hearing we will concentrate on the functional operation of the three major functional departments, that

is, exploration and production, refining, and marketing.

The evidence will disclose that Humble conducted no exploration or production activities of any nature in Wisconsin, and that no refining activities were conducted in Wisconsin either. In fact, the only activities in which the petitioner was engaged in Wisconsin during the years in issue, and since, was a relatively small amount of marketing. The marketing operations in Wisconsin are a carryover of the Pate Oil Company which Standard Oil of New Jersey acquired in 1956 and operated as a separate corporation until 1960. Pate was an independent marketer, and after the merger of Pate into Humble in 1960 Humble continued the same Wisconsin marketing operations, which Pate had been conducting.

Humble has always reported for Wisconsin income tax purposes on the basis of separate accounting, and during the years in issue it showed substantial losses arising from its Wisconsin marketing

operations. Such losses aggregated over $3,900,000 during the years in issue. The respondent, however, employed a hybrid version of the statutory apportionment formula, and reached the conclusion that the petitioner had substantial taxable income during each of the years of issue. Such taxable income totaled over $4,500,000 for the four years, which figure we think the Commission should particularly note because it is approximately $8,460,000 higher than the results shown by the petitioner's separate accounting. This very significant difference is important not only because of the dollar impact on the petitioner, which we submit is way out of proportion to its marketing activities within this state, but also because it represents a drastically different result than the respondent could conceivably justify on any assessment based upon the principles of separate accounting.

Therefore, it is our position that

by use of the apportionment formula respondent is attempting to reach and subject to Wisconsin tax income from non-Wisconsin independent functional operations which have no rational connection or nexus to petitioner's activities in the State of Wisconsin, principally exploration and production income.

We contend that such treatment constitutes both a violation of due process and a burden on interstate commerce. In addition, respondent has attempted to reach even further by aborting the statutory formula to drag in even more income to subject to tax. This aborted formula will be referred to by the petitioner as a "hybrid formula," and we contend that this hybrid constitutes an extension of the "over reach" of the apportionment formula itself. Furthermore, we feel the evidence will also show that the respondent's application of the apportionment formula subjects

the petitioner to the risk of multiple state taxation; and we contend that this risk of multiple taxation is not only burdensome to the petitioner, but that it constitutes a constitutionally impermissible burden on interstate commerce in violation of the commerce clause of the United States Constitution.

Our evidence in connection with petitioner's exploration and production function will demonstrate that it is organized and run as a separate business, and that the petitioner's corporate policy of functional profitability independence is carried out by the sale of a substantial portion of the crude oil to third parties at third party prices known as "posted field prices," and by the transfer of other crude to the petitioner's refining department also at the posted field prices.

The use of such prices for crude oil and similarly determined prices for natural gas, which prices are determined in each field in relation to arms length conditions,

and which the evidence will show are recognized as third party prices, establishes the integrity of the internal accounting for the net income of the exploration and production function; and the respondent has recognized the integrity of this net income determination in its own unpublished policies disclosed on discovery, and also has recognized this integrity by utilizing Humble's exploration and production net income figure as one of the base figures in its calculation of the portion of petitioner's exploration and production income which respondent deems apportionable.

The same functional profitability independence policy applies to the refining function, in that it acquires crude from outsiders and from petitioner's exploration and production function at posted field prices, and it sells and transfers the refined product to third parties at negotiated arm's length prices, and to petitioner's marketing department at such third party prices determined in relation to those

published in the accepted industry publication known as Platt's Oilgram.

Because of the integrity of the internal accounting for functional profits, the fact that each function stands alone and deals with other functions on the same basis as it deals with third parties, and the highly significant fact that no oil or gas from petitioner's exploration and production function comes into the State of Wisconsin to be sold as fuel oil, heating oil or gasoline, it should be clear that petitioner's refining and exploration and production functions are not integral parts of petitioner's marketing operations in Wisconsin.

On this factual background it should be clear that the respondent cannot by apportionment pull into Wisconsin for tax purposes a portion of petitioner's exploration and production or refining net income, thus creating Wisconsin taxable income way out of proportion to the possible profitability results of Wisconsin marketing operations. An authorization to use the

apportionment method certainly cannot be taken as a blank check to pull in and tax income that has no relationship to the taxing state.

Respondent contends that its use of apportionment is authorized by Section 71.07 (1) of the Statutes. The audit letter which accompanied the assessment in issue states the conclusion that petitioner "is an integrated oil company" and that since petitioner "is a unitary company and its Wisconsin business is an integral part thereof, formula apportionment of the company's income is mandatory and separate accounting is not permissible."

The evidence will demonstrate, however, just as the discovery proceeding has already demonstrated, that the respondent's audit made no real attempt to determine whether or not petitioner's business was unitary or whether its Wisconsin business was an integral part of a unitary business. Respondent's definition of "unitary," as expressed in its unpublished policy papers,

and on discoveryby its personnel involved with the audits of petitioner, demonstrate that respondent would treat any corporation with multi-state operations as a unitary business. Respondent's record would indicate that this is the interpretation it follows.

We submit, and suggest that the evidence will demonstrate, that the definitions used are so imprecise as to be of no value; and that respondent's over reaching interpretation does not conform to the language of the statute. The requirement that the business done in Wisconsin must be an integral part of a unitary business obviously does not apply where a taxpayer has separate functionally independent out-of-state businesses which are neither necessary to nor dependent upon the Wisconsin operations.

Our evidence will show that none of petitioner's functional departments are integral parts of a unitary business composed of all functions combined; rather it will show that each function is independent

and not unitary to or an integral part of any other function.

Respondent's deficiency assessment included approximately 40% of the exploration and production department income in apportionable income by the use of a barrel formula as part of the hybrid apportionment formula. Thus, it treated approximately 60% of the production income as allocable to the situs of the producing states. We contend that 100% should have been so allocated, or treated as income from an out-of-state business, so that no portion of income from the exploration and production business is includable in Wisconsin apportionable income, and that to include any portion would be in violation of the due process and commerce clauses of the U. S. Constitution.

Apportionment certainly is not a blank check authorizing the taxation of income that has no rational relationship to Wisconsin.

We contend that Section 71.07 of the

Statutes limits the imposition of the tax the case of corporations deriving income from within and without Wisconsin, so that only income from business transacted and property located within the State can be taxed.

We contend that the proper construction of this statute requires that each activity of the petitioner which is of substantial separateness from each other activity, must be regarded as a business, and that the statute must be applied to each such business separately. As already mentioned, the only business conducted within the State was marketing, and to include any part of the income derived from production business and properties in apportionable income would be to unconstitutionally tax extra-territorial income. If Section 71.07 were construed so as to tax such income, it would clearly be unconstitutional, and the application of the presumption of constitutionality dictates that such a construction should not be adopted.

The exploration and production function, we contend, is not only a separate business which is not an integral part of the marketing activities of the petitioner in Wisconsin, but all its income is also properly classifiable as income allocable to situs from the operation of a mine or quarry within the meaning of Section 71.07 (1), which has been consistently construed by the respondent to include oil and gas income in the category of income from mining.

Since the statute requires the allocation of situs income before an apportionment formula can be utilized, and since the separately determined Exploration & Production function income constitutes income from a situs operation, whether or not the crude and gas is transferred to Petitioner's Refining function, we contend that the proper construction of the statute would be to in any event allocate all Exploration & Production income to situs.

Since there is no "integral" relationship between Petitioner's Exploration & Production function and its business in the State of Wisconsin, or between its Refining function and its business in the State of Wisconsin, the only possible question is whether there may be an integral relationship between the Petitioner's marketing function and its activities in the State of Wisconsin. While we acknowledge that this may be a closer question, we believe that the acquisition of third party product at industry prices determined in relation to Platt's Oilgram,

the conduct of the Wisconsin marketing operations from a district office in Milwaukee, and the pattern whereby the Wisconsin marketing was the mere continuation of the business of a separate corporation which originally did business as Pate Oil Company before the business was acquired, should support the conclusion that Wisconsin operations were not even an integral part of the Petitioner's Marketing function.

This leaves the question as to whether petitioner's separate accounting for Wisconsin marketing operations fairly reflects the results of its operations in this State. Respondent's auditors have already admitted under oath on the discovery proceeding that they have no basis to challenge Petitioner's separate accounting reporting of Wisconsin sales and of the related Wisconsin cost of sales; and that only a few operating expenses might be questioned as possibly relating to more than mere Wisconsin activities, although it was pointed out that even to reduce such expenses in half

would not put the petitioner in a profit position in Wisconsin during any of the years in issue. Thus, we submit that the evidence will demonstrate that even giving respondent the benefit of the doubt on such expenses, a separate accounting calculation will not generate one cent of taxable income in Wisconsin during the years in issue.

As the Commission may recall from our Application for Discovery Authority, there are other deficiencies in the respondent's case relating to its use of a hybrid method employing a weighing factor not authorized by the statute, which permits use of other than the three factor statutory formula only when rules and regulations are prescribed as to such a hybrid method. No such rules have been prescribed. We intend to concentrate our efforts during the hearing on demonstrating the incorrectness of Respondent's position in denying use of separate accounting and requiring apportionment which subjects to Wisconsin taxation petitioner's refining and exploration & production functions.

It is our intention, however, to preserve the question of whether respondent can refuse to make available the working papers it admittedly used as a model for the audit of the petitioner, having admittedly not prescribed and published any rules and regulations explaining its method; and to preserve the equal protection question as to whether the respondent must respond to inquiry as to whether other oil companies are being afforded the same or similar treatment, and allowing the petitioner to examine departmental witnesses on apparent inconsistencies in filed cases with other oil companies. In determining to concentrate during the hearing on the constitutional and statutory issues raised, petitioner has determined, despite the considerable complexity of respondent's apportionment calculations, and the possible deficiencies in the mechanics of such calculations, that it will not take the Commission's time to explore in depth the mechanics of the calculation; but rather after demonstrating certain arbitrary and erroneous assumptions

used, we will concentrate on the issue of whether the apportionment method can be applied generally to petitioner's overall operations.

We will present as an exhibit a calculation showing possible Wisconsin taxable income or loss under certain possible alternative conclusions, which include: (1) separate accounting for Wisconsin marketing operations, (2) apportioning and taxing only petitioner's marketing function, (3) apportioning and taxing only petitioner's marketing and refining functions, and (4) treating petitioner's exploration & production function as a separate non-Wisconsin business or as income allocable to situs.

Before closing I want to highlight for the Commission what we view to be the overriding issues for determination:

1st. Does Section 71.07 of the Statutes permit the respondent to refuse to accept the petitioner's unchallenged separate accounting results for its Wisconsin operations, and impose upon it the apportionment method as

to some or all its income from functionally independent departments? That is, are some or all of petitioner's functional departments unitary businesses and are its Wisconsin marketing functions an integral part of any such unitary business?

2nd. Even if the respondent is deemed authorized to use the apportionment method, can it be applied to operations which are functionally independent or to income which is clearly derived from situs operations, both of which have no connection to Wisconsin marketing operations.

3rd. Does an authorization to use apportionment allow the respondent to apply it in such a manner as to subject millions of dollars to Wisconsin taxation that have no rational relationship to the marketing operations in this State and are way out of proportion to any possible profit potential of this Wisconsin marketing business?

Because of the precedential importance of the issues in this case, and the legal and factual complexity, I strongly urge each

member of the Commission to make every effort to be present at all session of this hearing. In order to properly assimilate the evidence we submit, it will be very helpful to hear all of it in logical sequence and to examine the exhibits. We will be presenting significant constitutional issues for the Commission's determination, and I submit that the Commission will not be able to adequately decide this case without coming to grips with these constitutional issues. I urge the Commission not to duck these issues, and to accept the responsibility vested in it by making decisions on the constitutional questions. Otherwise the outcome will not be meaningful for either the petitioner or the respondent as to the basic issues.

Because of the complexity of this case I have dealt at some length in this opening statement, with both the factual background and with an identification of the issues and theories to be presented by the petitioner, in the hope that it will help the Commission to more quickly grasp

the key aspects of the evidence to be presented, and will give it a better initial perspective to view the serious constitutional issues.

Closing, I would like to say that the facts which we will present in our view will present a classic case of "over reach" and I trust that after you have assimilated the factual situation and reviewed the law, you will agree that the State's assessment and procedures have far exceeded the bounds of fair play and substantial justice required by the constitution.

Thank you.

STATE OF WISCONSIN

WISCONSIN TAX
APPEALS COMMISSION

* *

EXXON CORPORATION, (f/k/a Humble
Oil and Refining Company),

Petitioner,

- vs -

Docket No. I-3806

WISCONSIN DEPARTMENT OF REVENUE,

Respondent.

* *

CERTIFICATION

KAREN A. CHERRY
MINDLA COMINS
LORETTA PETERS,

hereby certify that as the duly appointed reporters, we took in shorthand the testimony and proceedings had in the foregoing matter on the 2nd day of October, 1974, and that the attached is a true and correct transcription of said shorthand notes and of the whole thereof.

Dated this 2nd day of October, 1974.

Karen A. Cherry

Karen A. Cherry

Mindla Comins

Mindla Comins

Loretta Peters

Loretta Peters

STATE OF WISCONSIN — WISCONSIN TAX APPEALS COMMISSION

* *

EXXON CORPORATION, (f/k/a Humble Oil and Refining Company),

Petitioner,

-vs- Docket No. I-3806

WISCONSIN DEPARTMENT OF REVENUE,

Respondent.

* *

TRANSCRIPT OF PROCEEDINGS in the above-entitled matter held before the Wisconsin Tax Appeals Commission, in Room 229, City-County Building, Madison, Wisconsin, on the 3rd day of October, 1974, commencing at 9:45 in the forenoon.

PRESIDING: R. J. SMRZ, Chairman
THOMAS R. TIMKEN, Member
JOHN P. MORRIS, Member

ALSO PRESENT: JAY C. GITCHELL, Hearing Examiner

A P P E A R A N C E S

BOARDMAN, SUHR, CURRY & FIELD, Attorneys at Law, 131 West Wilson Street, Madison, Wisconsin, by THOMAS G. RAGATZ,

and

McBRIDE, BAKER, WIENKE & SCHLOSSER, Attorneys at Law, 110 North Wacker Drive, Chicago, Illinois, by LLOYD M. McBRIDE and PAUL D. FRENZ,

and

ROBERT E. TANNEHILL, Tax Attorney, Exxon Company, Houston, Texas, appearing on behalf of Petitioner.

IRVING F. SHAPIRO and ROBERT M. FINLEY, Tax Counsel, Wisconsin Department of Revenue, 201 East Washington Avenue, Madison, Wisconsin, appearing on behalf of Respondent.

Q From an ~~accountant~~ (accounting) stantpoint, Mr. Garno, isn't it a fact that unrealized income, net income derived, can be determined on a functional basis?

A You are not referring to tax accounting?

Q I am referring to generally-accepted principles of accounting consistently applied.

A Yes.

MR. RAGATZ: No further questions.

MR. TIMKEN: You are excused, Mr. Garno.

(Witness excused)

MR. TIMKEN: You may call your next witness.

MR. RAGATZ: The petitioner calls Mr. Oral Luper.

ORAL L. LUPER,

called as a witness, and after being first duly sworn, testified on oath as follows:

(Exhibits 19 A, B, C and D marked for identification)

MR. RAGATZ: We have just marked Exhibits 19 A, B, C and D which are copies of pages of the Milwaukee Journal, one taken from each of the years 1965, 6, 7, 8. And this is an exhibit of the respondent but it will

be introduced at this time (stipulating) that it is authentic, and so that the current witness can be examined on it both on direct and on cross.

MR. TIMKEN: Mr. Shapiro, do you so stipulate?

MR. SHAPIRO: We so stipulate.

MR. TIMKEN: Exhibits 19 A, B, C, and D are received.

EXAMINATION

BY MR. RAGATZ:

Q Would you give you full name?

A My name is Oral L. Luper.

Q Where do you live?

A I reside at 11107 Meadowick Drive, Houston, Texas.

Q How old are you?

A I am 60.

Q Would you briefly summarize your academic background?

A I attended the University of Oklahoma from the years 1931 and graduated in 1936; received a Bachelor of Science degree from the School of Business Administration in 1936.

Q And what was your major?

A Accounting.

Q Did you take any post graduate work?

A Yes, I took post graduate work at the Northwestern University in Chicago, Illinois in the years 1937-38.

Q And are you a Certified Public Accountant?

A Yes, in the States of Texas and New York.

Q And how long have you been a CPA?

A About 34 years I believe.

Q Would you trace your private employment history after graduating from college?

A When I graduated from the University of Oklahoma I became employed with the El Reno Mill Elevator Company in El Reno, Oklahoma, a subsidiary of General Mills, Inc.

Q In what capacity were you employed there?

A As an accountant.

Q And what responsibilities did you have?

A Primarily the maintenance of inventory records and the determination of product cost.

Q What kind of product was this?

A ~~Seed~~ (Feed). Flower and ~~seed~~ (feed).

Q And how long were you with General Mills?

A About six months.

Q And what was your next employment?

A I was employed then by Price Waterhouse and Company in Buffalo, New York.

Q And what were your duties with that employment?

A I was a staff accountant then.

Q In ~~And~~ public accounting practice?

A Public accounting practice, engaged in auditing of various companies.

Q What kinds of businesses did you have experience auditing?

A Oil and gas companies, airplane, electronics, utilities.

Q How long were you with Price Waterhouse?

A Till 1941.

Q And what happened in 1941?

A I entered the U.S. Armed Services.

Q And what branch were you in?

A In the Quartermaster Corps.

Q And how long had you served ~~.....~~ in the armed services, Mr. Luper?

A From April 1941 until April of 1946, I believe.

Q Did your work in the armed services have anything to do with your academic background or your prior experience?

A Only in a general way.

Q What employment did you accept upon the release from the armed services?

A I was employed by the Humble Oil and Refining Company in Houston, Texas.

Q And that was what year?

A In 1946.

Q What was your first position?

A I was a supervisor of a systems and staff.

Q And this related to accounting?

A Yes, this was involved in accounting systems, financial reporting systems --all types of systems related to financial information.

Q Now would you generally trace the different positions you have held with Humble from that time forward?

A Well, after I believe it was in 1949 I became assistant general auditor and in 1950 I became general auditor for the company; and in that capacity I was responsible for directing new activities of the company's internal audit staff which involved the auditing of the various accounting, financial departments of the company, the auditing of the operational departments of the company, the auditing of other companies with whom we had joint ventures, the auditing of contractors which were employed on a

cost-plus basis, same activities.

Q How long did you serve in that job?

A In 1952 I believe it was I became assistant to the comptroller and then in 1953 I became the comptroller of Humble Oil and Refining Company.

Q Was the comptroller of Humble, as it is with many companies, the chief accounting officer?

A Yes, it was.

Q Would you describe a little bit the duties and responsibilities of that position?

A As the comptroller of Humble I had responsibility for directing and maintaining the accounting systems of the company including responsibilities for the development and implementation of budgeting plans, the development and planning and maintenance of planned work for financial reporting, the development of the systems for financial forecasting, supervision of the internal audit staff, supervision of the systems and computing staff.

Q What was your next position?

A In 1959 I became comptroller of a new company which is also Humble Oil and Refining Company, but this was the Humble Oil and Refining Company of Delaware. This new company came as a part of a reorganization in

which the Standard Oil Company of New Jersey acquired the entire stock ownership of Humble Oil and Refining Company of Texas, the former company. And shortly thereafter the domestic petroleum companies, which were wholly owned (subsidiaries) ~~subsidiary~~ of Standard Oil Company of New Jersey, were merged into the new Humble Oil and Refining Company of Delaware at, I believe, December 31, 1959.

Q How long did you serve in that capacity?

A Until 1962.

Q Now, during that period was that the time that the subsidiary Pate Oil Company that we talked about in the stipulation in this case was merged into Humble Oil and Refining Company?

A Yes. The Pate Oil Company was merged into the Humble Oil and Refining Company of Delaware, I believe, on June 30th or July 1st of 1960.

Q Thereafter the business of Pate was continued by Humble?

A Yes, it was.

Q What was your next position?

A I became a general manager of the ~~FO~~ (Esso) Standard Eastern Region of our Marketing Department in 1962.

Q What were your duties there?

A I was responsible for the marketing activities of that region.

Q How long did you have these responsibilities?

A Until 1963 when I became the assistant to the president of the Standard Oil Company of New Jersey.

Q Identify the relationship between Standard Oil of New Jersey and Humble Oil and Refining at that point in time.

A At that point in time the Standard Oil Company of New Jersey was the parent of Humble Oil of Delaware and it was a wholly-owned subsidiary.

Q What business did the Humble Oil and Refining Company conduct during that period? Was it involved in foreign operations or was it restricted to domestic operations?

A The operations of Humble Oil and Refining were strictly domestic operations ~~of~~ in the United States. ~~Petroleum operation in the United States.~~

Q How long did you serve in that capacity?

A Until 1963.

Q And then what position did you take?

A I became the assistant to the Chairman of the Board of the Standard Oil Company of New Jersey.

Q What were your duties there?

A My duties there were to assist the chairman in the matters he had to consider at Board meetings, (and) executive committee meetings. I analyzed and evaluated matters that required his attention. I assisted him by providing (liaisons) lays on communications, links between him and other members of the organization and other representatives of the subsidiary companies.

Q When did you become a director of the Humble Oil and

Refining Company?

A In 1965.

Q How long did you serve as director?

A I served as director until January 1st, 1973.

Q And that was when Humble was merged into the Exxon Corporation, the present corporation?

A Yes.

Q How long did you continue as the assistant to the Chairman of the Board of Standard Oil of New Jersey?

A It was a little over a year.

Q What was your next position?

A Director of Humble Oil and Refining Company in 1965.

Q And what position did you assume next?

A I was a director of the company and later became a vice-president.

Q What were your duties as vice-president?

A I was responsible primarily for the financial activities of the company which embraced the general supervision of the comptroller's department, the treasurer's department, the tax department, and later the land management department. I was also responsible for certain insurance activities and later I became associated with real estate activities.

Q And what was your next position?

A Well, I became a senior vice-president of the Exxon Company, U. S. A., on January 1st, 1973. That was the time -- on that date -- the Humble Oil and Refining Company of Delaware was merged into the Exxon Corporation. The Exxon Corporation had previously been the Standard Oil Company of New Jersey. After the merger of Humble Oil into the Exxon Corporation at the beginning of 1973, the operations and activities of the former Humble Oil and Refining Company were ~~[illegible]~~ assumed and carried on in almost an identical manner as of the Exxon Company, U. S. A., as a division of the Exxon Corporation.

Q And your present position with the company?

A At present I am Senior Vice-President of the Exxon Company, U. S. A., and a member of its management committee. The management committee was created as a substitute for the former Board of Directors.

Q On your current position maybe you could sketch your major responsibilities.

A In my present position?

Q Right.

A I am -- my general responsibility is for the financial activities of the company. I am executive contact for the comptroller department, the treasurer's

department, the tax department and the land management department. In addition I am the shareholder contact with two subsidiary companies, one a wholly-owned subsidiary engaged in land development activities, and the other a wholly-owned subsidiary engaged in insurance activities.

Q In the aggregate how much time do you have in the oil and gas industry in years?

A Over 28 years.

Q Would you describe professional societies and organizations that you belong to?

A I am a member of the American Institute of Certified Public Accountants and a member of its Board of Directors. I am a member of the Accounting Research Association which is the research arm of the American Institute. I am a member of the Texas Society of Certified Public Accountants. I am a member of the Financial Executive Institutes. I am a Trustee of the Financial Executive Research Foundation which is the research arm of Financial Executive Institutes. I am a member and a director of the Texas Manufacturing Association. I am also a member of a number of civic and cultural organizations, and I should mention that I am a member of the American Petroleum

Institute.

Q Have you served as a member of the Accounting Principles Board?

A Yes, I have.

Q For how long?

A A little over -- about seven years.

Q Could you briefly describe for me any books or articles you have written on the subject germane to the issues in this case?

A I really haven't written any books or articles really germane to this case.

Q How about to oil and gas accounting?

A I really haven't -- I have had some -- I believe one article published in this area, but not particularly involved in this case.

Q Would you just mention the names of the publications in which you have articles published just as part of your background?

A Well, I have an article published in the Journal of Accountancy, (and) the Financial Executive Institute publication. I was a contributing author to the Financial Officer's Handbook.

Q Did you mention the Journal of Accountancy?

A Yes.

Q Have you held any academic positions over the years?

A Well, at the University of Oklahoma I was an accounting laboratory instructor and when I was taking graduate work at the Northwestern University I (held) ~~was~~ a teaching fellowship.

Q I would like you to describe the corporate organizational structure of Humble Oil and Refining Company for the years 1960 through 1968.

(Exhibit Number 20 marked for identification)

Q I show you what has been marked Exhibit 20 and ask you to identify that, please.

A This is an exhibit entitled "Humble Oil and Refining Company Corporate Organizational Structure of 1960-1968." It contains a brief outline of the organizational structure.

Q Was this prepared at your direction?

A Yes, it was.

Q Does it set forth (the) organizational structure during this period?

A Yes, it does.

MR. RAGATZ: I would like to move the admission of this exhibit.

MR. TIMKEN: Any objection?

MR. SHAPIRO: No objection.

MR. TIMKEN: Exhibit 20 is received.

BY MR. RAGATZ:

Q I would like you to describe, first of all, the corporate management functions shown on the exhibit.

A Well, as you can see, or as the exhibit demonstrates, the basic organizational structure of Humble was in three parts. The corporate management was the principal, the highest order of management in the company and represented the executive management (of the) ~~in a~~ company. It was composed of the Board of Directors, the Executive Committee, the Chairman of the Board, who was also the chief executive officer, the president and the directors in charge who were members of the Board of Directors.

Q Would you describe the Board of Directors briefly, please?

A The Board of Directors was composed of eight members. It had the responsibility for the overall direction and operation of the company, responsible for the broad policies of the company. It elected the officers and declared the dividends, reviewed the overall goals and objectives of the company.

Q How did the Executive Committee operate?

A The Executive Committee -- the Board of Directors has delegated to the Executive Committee all the powers of the Board with the exception of certain powers such as the election of officers, the declaration of dividends and other matters which we restricted to the Board. (That is) ~~It's~~ from a legal point of view.

Q The Executive Committee operated in absence of the Board and on these matters?

A Yes.

Q And how did the Chairman of the Board fit into the organization? What were his responsibilities?

A The Chairman of the Board was, of course, the Chairman of the Board and he was the chief executive officer of the company. As such he had the responsibility for implementing the policies and decisions of the Board of Directors. He was also, of course, the company's principal spokesman with the public at large.

(Recess)

MR. TIMKEN: We will go back on the record.

BY MR. RAGATZ:

Q Would you describe the responsibilities of the President?

A The President in the absence of the Chairman of the Board acted as ~~Vice~~ Chairman of the Board. He was also responsible for the overall administration of the company's activities, and in the absence of the chief officer he acted for him.

Q How were the directors in charge designated? How was that designated? How was that carried out?

A The directors in charge were first of course members of the full-time Board of Directors, but in addition they were the executive officers of -- having general responsibilities for specified operating departments or coordination and service department.

Q Let's move to the coordination and services, management level, and would you describe that?

A Well, the next segment of the organization structure is referred to by us as the Coordination and Services Management, and this is composed of corporate staff departments. The responsibility of this management

group, is, of course, to provide the overall specialized corporate services that are needed by the corporation overall. Their department advised the corporate officers and the Board of Directors, they advised the operation's management, and also they advised as needed the management of the other service -- other staff departments.

Q Well, let's take the various staff departments that compose the Coordination and Services Management. Would you describe the Corporate Planning Department?

A The Corporate Planning Department was responsible for the long range planning of the company. It was responsible for assisting and developing the overall company strategies, and advised the Board in a manner to try to maximize the overall company operations, the effectiveness of the operations.

Q How did the Secretary's Department operate?

A The Secretary's Department provided a secretary for the Board of Directors and a secretary for the Executive Committee. The Department maintained the official corporate records, the charter and by-laws, and they provided and maintained the minutes of the meetings of the Board of Directors, and the Executive Committee, and they also were responsible for the area

of executive compensation, executive development and training, and general advice in the corporate affairs of the company.

Q How about the Supply Department?

A The Supply Department was responsible primarily for the purchase and sale of raw crude and raw materials and acted as a coordinating group between the refining and other operation functions, so as to obtain an optimum short range operating program.

Q Now this is not an operating department as such, though, was it?

A It was not an operating department, no. It was a -- we did not consider this a profit center.

Q Would you describe the Treasury Department?

A The Treasurer's Department was headed by the Treasurer of the company, who had responsibility for all of the financial resources of the company, responsible for the development of financial policy and procedures, and maintained banking relations, developed plans for the appropriate financing of the company's activities, and provided an analyses of the financing aspects of the proposed investments.

Q And the Comptroller's Department?

A The Comptroller's Department was headed by the

Comptroller and the Comptroller was responsible for the overall maintenance of the company's accounting systems and in charge of the books of account of the company. It involved procedures and plans related to the appropriate systems of capital budgeting throughout the company providing appropriate systems for financial reporting, appropriate systems for financial forecasting, and they were responsible also for operating the computing -- some of the computing centers of the company, maintaining a systems staff, and finally maintaining an overall system of internal control and responsibility for the internal audit staff.

Q But these functions did not include the accounting for each operational function, I take it?

A As I will explain later, the operation functions have separate accounting offices. The comptroller had responsibility for an accounting office that maintained the corporate records, the consolidated financial reports.

Q And this is the department that you headed up for a period of time?

A I did in the early 60's, yes.

Q Would you describe the Tax Department?

A The Tax Department was headed by the general tax counsel, the Department is responsible for providing tax counsel and tax advice to all departments of the company, and have responsibility for the determination of the appropriate tax liability of the company to the various governmental authorities.

Q And again this was the overall company tax liability, not the responsibilities of each operational function ?

A The Tax Department was responsible for the tax administration to the company, but some of the operation departments did have personnel in their organization to carry out the routines of some of the tax reporting requirements is all, some of the routine reports that are required.

Q Now the Law Department?

A The Law Department was headed by the general counsel of the company, and the Department provided legal counsel for the Board of Directors, the officers of the company, and the other management groups within the company.

Q The Public Relations Department?

A The Public Relations Department had the responsibility for promoting an understanding of the company's

character and its goals and its performances with the general public. They were responsible for the maintaining and communication and information service to the public, to governmental authorities, the media and other outside parties.

Q This is not the advertising function?

A No, the advertising function was performed in the Marketing Department.

Q Describe the Government Relations Department.

A The Government Relations Department was responsible for coordinating the company's government relations activities, and was responsible for liaison with the government officers at the federal level and in the State of Texas.

Q The Employee Relations Department?

A The Employee Relations Department was primarily reponsible for providing a competent and able work force within the company. They were responsible for developing plans and procedures for salaried administration and training, employee development, employment, the details of plans for employee benefits, and advice on labor relation matters.

Each operating function had its own personnel people and its own labor relations?

A Yes, they did.

Q Describe the General Services Department?

A The General Services Department was responsible for providing the corporation with office facilities and all of the office services such as printing and reproduction and janitorial services, the very varied services that are required for the everyday routines and operation of the corporation.

Q Medical Department?

A The Medical Department was concerned with the industrial hygiene of the company and advised the company on the health of the employees and provided assistance and advice to employees on a professional basis.

Q The Aviation Department?

A The Aviation Department was responsible for operating the company's aircraft and its fixed base facilities for aircraft.

Q Now looking again at Exhibit 20, would you identify which of the functions of the Coordination and Services Department you have just described have been under your jurisdiction and for how long?

A Well, the Treasury, Comptroller's, and Tax in the Coordination and Services group, and the land management activities in the Operations Management group,

and these have been under my -- among my responsibilities since I first became a director of the former Humble Oil and Refining Company in 1965. The Land Management Department was added two or three years later.

Q Now before describing the specific operating departments, would you give us a little background on the organizational setup of the operating management, the functional operating departments of the company?

A The operations management of the company was responsible for directing the operating activities of the individual functional segments of the company. Each functional segment was organized into a separate department which operated independently of each other operating segment and was organized in a way so that it could perform pretty much on a stand-alone basis as a separate, single function company.

The operating departments were headed by either a vice-president, which was true in the major operating departments, and headed by a general manager in the departments that were not ~~in the operating departments that were not~~ quite as large.

Q In terms of financial management, how were these operating department set up?

A Each operating department is responsible for its own performance, both operationally and financially. It has been the philosophy of the company's management for a long-standing period that each department

is evaluated separately and independently of each other department from a profitability standpoint and operational standpoint and overall performance.

Q Is what you are referring to now what the company calls the policy of functional profitability independence?

A Yes, that's correct.

Q And is what you referred to a few minutes ago about each function having to stand alone as against other functions and as against competitors known as the functional stand-alone policy?

A Yes.

Q Would you describe how this policy is intended to have the individual functions put where they could compete with other functional departments or other independents in the industry in that particular activity?

A Well, it's been the view of our management, executive management, that by having each department independently responsible for its function performance is one of the most effective management tools that we can use in measuring the performance of the departments and to improving their operations. Under this plan each department is in competition with each

other and which results, of course, in competition for the available funds for investment in the business activities of each of these operating functions.

Q In effect are each of these functions also in competition with the other members of the industry operating in the same function?

A Yes. There are companies with any industry which perform only one function or one segment of the petroleum business. Some perform more than one, but I will describe later which operating functions of the Humble Company were in competition with these other companies.

Q Would you describe the exploration and production function?

A The exploration and production function really is composed of three departments; exploration, production and natural gas. The Exploration Department is headed by a vice-president and he has responsibility for the profitable acquisition of reserves, of crude oil and gas. To do this, of course, means the providing the technical supervision of geological and geophysical activities that are involved in the activity of exploring for oil and gas reserves.

Also he has responsibility for land acquisitions, mineral fee acquisitions and providing the company with both short-term and long-term operating plans for the Exploration Department.

Q As distinguished from the Production Department, the Exploration Department doesn't do anything except locate the --

A They carry on the exploratory effort needed to find potential oil and gas reserves and then they are responsible for drilling the wildcat exploratory wells to determine whether or not the reserves do in fact exist. And if that turns out to be the case, why then the properties are turned over to the Production Department for further development.

Q Now describe the activity of the Production Department.

A The Production Department again is headed by a vice-president. And this department was responsible for the profitable operation of all of the companies producing oil and gas properties including the operation of the natural gas plants and the related facilities.

This involved, of course, maintaining a technical staff, providing engineering service.

petroleum engineering advice and counsel, the development of drilling programs, the development of operational programs, and, again, was responsible for its proper performance in the producing of oil and gas.

Q Now describe the Natural Gas Department.

A The Natural Gas Department was headed by a general manager and it was responsible for the profitable purchase and sale and distribution of natural gas. This department is considered to be an operating department and its grouped with Exploration and Production because of the close coordination that's required between their activities and those of the Production and Exploration Department. But the Natural Gas Department is not a profit center. Its records of its transactions are combined with those of the Production Department because the physical facilities, of course, are common to both products, oil and gas.

Q All three of these departments, that is, Exploration, Production and Natural Gas, are part of the exploration and production function for accounting purposes?

A Yes.

Q Now would you describe the Refining Department?

A Well, the Refining Department was headed by a vice-president. This department is responsible for the profitable operation of the company's refineries and associated facilities which manufactured petroleum products, special products and petro chemcial feed stocks.

Q And describe a little more the functional organization of this department.

A This department, of course, the headquarters of this department were located atthe corporate headquarters. To assist it they have a Planning Department, rather, a planning group to assist in the planning of refining operations. They have an administrative group which was involved with the contractual and the affairs of the department, the employee relations activities of the department; and an operating group which is responsible for coordinating the activities of the existing refineries.

Q Would you describe the Marketing Department?

A The Marketing Department was headed by a vice-president. It is responsible, of course, for the profitable distribution and sale of petroleum products through the company's marketing facilities.

The vice-president has independent staff

groups organized and provided to serve the Marketing Department. These include such groups as, again, the planning activity, the staff group, administrative staff group to concern itself with employee relations matters and administrative matters. It has an advertising group which is responsible for developing the company's, or rather the marketing advertising plans and sales promotion programs. It has a distribution staff responsible for the engineering and planning of the physical facilities needed in the distribution system which involves, of course, the operation of terminals, tank trucks and other similar facilities.

And, finally, of course, there is an operating group which is responsible for coordinating the marketing activities of all the field organization.

MR. TIMKEN: Mr. Ragatz, Mr. Shapiro, do you think this is a good time to break; it is almost 4:30.

MR. RAGATZ: That's fine.

MR. TIMKEN: Very well. We will adjourn then until 9:30 tomorrow morning.

(Hearing adjourned, 4:25 p.m.)

STATE OF WISCONSIN

WISCONSIN TAX APPEALS COMMISSION

* *

EXXON CORPORATION, (f/k/a Humble Oil and Refining Company),

Petitioner,

vs.

Docket No. I-3806

WISCONSIN DEPARTMENT OF REVENUE,

Respondent.

* *

CERTIFICATION

KAREN A. CHERRY
MINDLA COMINS
LORETTA PETERS,

hereby certify that as the duly appointed reporters, we took in shorthand the testimony and proceedings had in the foregoing matter on the 3rd day of October, 1974, and that the attached is a true and correct transcription of said shorthand notes and of the whole thereof.

Dated this 3rd day of October, 1974.

Karen A. Cherry

Karen A. Cherry

Mindla Comins

Mindla Comins

Loretta Peters

Loretta Peters

STATE OF WISCONSIN | WISCONSIN TAX APPEALS COMMISSION

* *

EXXON CORPORATION, (f/k/a Humble Oil and Refining Company),

Petitioner,

vs. Docket No. I-3806

WISCONSIN DEPARTMENT OF REVENUE,

Respondent.

* *

TRANSCRIPT OF PROCEEDINGS in the above-entitled matter held before the Wisconsin Tax Appeals Commission, in Room 229, City-County Building, Madison, Wisconsin, on the 4th day of October, 1974, commencing at 9:40 in the forenoon.

PRESIDING: R. J. SMRZ, Chairman
THOMAS R. TIMKEN, Member
JOHN P. MORRIS, Member

ALSO PRESENT: JAY C. GITCHELL, Hearing Examiner

APPEARANCES

BOARDMAN, SUHR, CURRY & FIELD, Attorneys at Law, 131 West Wilson Street, Madison, Wisconsin, by THOMAS G. RAGATZ,

and

McBRIDE, BAKER, WIENKE & SCHLOSSER, Attorneys at Law, 110 North Wacker Drive, Chicago, Illinois, by LLOYD M. McBRIDE and PAUL D. FRENZ,

and

ROBERT E. TANNEHILL, Tax Attorney, Exxon Company, Houston, Texas, appearing on behalf of the Petitioner.

IRVING F. SHAPIRO and ROBERT M. FINLEY, Tax Counsel, Wisconsin Department of Revenue, 201 East Washington Avenue, Madison, Wisconsin, appearing on behalf of Respondent.

ORAL L. LUPER,

recalled as a witness, having been previosly sworn under oath testified as follows:

MR. MORRIS: Let the record note that this is a continuing hearing and, Mr. Luper, you are still under oath to tell the truth to the best of your knowledge and ability.

Counsel, before we allow you to continue your examination, I have been informed this courtroom is available all next week. We will continue to use this courtroom until further notice.

The exhibits, if necessary, can be placed in a safe with the Clerk of Circuit Court which is in the Law Library, which is next to us here. If you so request and wish, they will be locked this evening. The exhibits in front of me will be placed in safes and returned back to this courtroom on Monday.

The hearing, if it is to continue beyond today, will be scheduled for commencing -- no, I should say scheduled for hearing at 10:00 o'clock on Monday; and we will continue

until this hearing is completed next week. If we need to go beyond the next week, we will then have to reserve a different courtroom, I think, and you will be given notice as to that.

Are there any special requests before we continue the examination, Mr. Ragatz?

MR. RAGATZ: Point of inquiry. Is the 10:00 o'clock starting time just for Monday?

MR. MORRIS: Just for Monday.

Mr. Shapiro, do you have any special requests?

MR. SHAPIRO: No, sir.

MR. MORRIS: You may proceed in your examination, Mr. Ragatz.

EXAMINATION

BY MR. RAGATZ:

Q Mr. Luper, before we closed yesterday you had described the functional operations of what you described as the three major departments, exploration and production, refining and marketing.

Would you next describe the functional operation

of the Marine Department?

A Yes. The Marine Department was headed by a general manager. The Department was responsible for the profitable waterborne transportation of the company's petroleum products. The Department was also responsible, of course, for the safe and efficient operation of the waterborne equipment, ocean tankers and inland waterway equipment and, of course, operated the branch offices that were necessary for the operation of those vessels.

Q And did this operation and Marine Department include the charter service?

A Yes. If there was any additional transportation, water transportation required, this Department took care of both in chartering and the out chartering.

Q Did you have any operations in this Marine Department conducted on the Great Lakes?

A Not to my knowledge.

Q And then there were not operations that tankers or other shipping came into ports in Wisconsin?

A No.

Q And how about the Mississippi River?

A The Department did operate inland waterway vessels on the Mississippi River.

Q Up as far as Wisconsin to the best of your knowledge?

A I believe no further than Chicago.

Q Are you aware of any other possible activity of this Department that would have any relation whatsoever to the State of Wisconsin?

A No, I do not.

Q Was this Department operated as a special functional operation in the manner you have described for other departments?

A Yes, it was.

Q Would you next describe the coal and the shale oil department?

A The coal and shale oil department was also headed by a general manager and he was responsible with his department for acquiring and operating -- Well, excuse me.

He was responsible for exploring for and locating and acquiring deposits of coal and shale and for conducting all the operations incident to the mining and milling of that hydrocarbon deposit.

Q And generally where did these operations occur?

A They occurred in Illinois principally in some of the middle states and in the western states, Wyoming principally.

Q And these are where these deposits are located?

A That's where the deposits are located and the field activities of this department are conducted at the situs of those deposits.

Q Are there any such operations in the State of Wisconsin?

A No.

Q Did this functional department have any other relationship whatsoever to the activities of Humble in the State of Wisconsin during the 1960's?

A No.

Q Would you describe the operation of the Minerals Department?

A The Minerals Department was again headed by a general manager responsible for the exploration and discovery and acquisition of the non-hydrocarbon mineral deposits and was also responsible, of course, for the development of necessary mines and related facilities necessary to mine those deposits profitably. This department also operates as a separate independent operating function.

Q Where were the operations of the department centered?

A The field activities of this department were wide spread over the entire United States and Alaska.

Q To the best of your knowledge were there any activities in the State of Wisconsin?

A Not during the period 1960 to '68.

Q Did this department have any other relationship to the marketing activities that were conducted in the State of Wisconsin to the best of your knowledge?

A No.

Q Now as to both of these latter two departments, were they doing anything to the minerals other than extracting them from the earth?

A Well, during the period that we are discussing we had no coal mines in operation and we had no other mines in operation either.

Q Would you describe the function of the Land Management Department?

A The Land Management Department was headed by a general manager and his responsibility in his department was administering and disposing of the surplus properties that became surplus during the course of the company's operations.

Q And what if any relationship did the activities of this department have with the State of Wisconsin?

A There were probably a few surplus service station sites that this department was responsible for

disposing of.

Q And there will be another witness who can probably answer this question directly but, if you know, were the results of the sales of any Wisconsin properties allocated to situs for purposes of the Wisconsin separate accounting reporting?

A It is my understanding that any profit or loss in the disposal of these Wisconsin properties was allocated to the activities of Wisconsin.

Q Now you have covered the corporate organizational structure in summary form, but I would like you to discuss the characteristics and elements of the functional operating departments in a little more detail describing some of these key elements, if you would, please.

A Well, as I have said before, the principal departments ~~was~~ were the exploration and production, refining and marketing departments. Historically the basic organization structure of the company recognized these separate departments as independent, separate functions. This was demonstrated not only by the organization structure but it was also demonstrated by other policies and procedures and by the arrangement and configuration of the physical facilities involved

in their operations.

Q Is what you are mentioning here again related to what you described yesterday as the functional profitability independence policy of the company?

A Yes. And just to illustrate some of the additional policies and procedures and the arrangements for physical facilities, just let me name a few.

First, each of the operating departments had its own separate management responsible for the proper conduct of that operation. Each of these management managers had a technical staff to provide all the supporting technical service that he needed to operate his particular operation. He also had the administrative staff when necessary to assist him. Each of these departments had its own separate and distinct field organization which conducted the operations in the field.

Q Was there or was there not, as to each of these functional operating departments, a full management complement for each?

A Yes, there was. That was the point I am trying to make. Each of the departments was responsible for the operation of the, or conducting the operations of this particular segment and operating the facilities

that was involved in that operation.

Each department had a separate profit center which provided a means for recording the transactions involving expense and revenue so that a profit for that function could be determined.

Each department was recognized as an investment center. I mean by that that records were maintained for each of these departments to reflect the investments in properties and fixed plant and the operation of those properties so that the management of that department could be held to a stewardship of his operation of these particular properties. There was in existence a system of providing values for the transfers of raw materials and products interfunctionally between departments that is.

The purpose, of course, of having a system of a policy on transfer values for movements of products and raw materials between departments was to provide a basis for determining the functional ~~proper~~ profit or loss of each of these major segments.

Q Before you discuss that further, as background would you mention types of goals and operating programs that these functional departments have?

A Well, each of the departments was responsible, of course, for preparing and developing its goals and objectives. Each was responsible for developing the programs required to reach these objectives. I might add here that the attractiveness of an investment in refineries is directly related to the adequacy and ~~secrecy~~ stability of the source of raw materials and crude. The attractiveness of this refining investment is also directly related to the adequacy and assured outlet for the products, and, this, of course, means that where assured and stable supplies of raw materials and assured outlets for products exist, the refining investments become attractive so that, therefore, a refinery is most interested in a quality and type of crude that is available to it and not so much in the ownership of the crude or the source from which it is produced.

By the same token, the Marketing Department is responsible -- is interested in the type and quality products that are received from the Refining Department so this just means, I think,

that when you have the exploration and production activities and the assured market outlets, there is less opportunity for disruption due to fluctuation and the demand and supply balances.

Q Now, did company policy require a mandatory flow through of the produced crude to the marketing outlets?

A No, as I said earlier, because the Refining Department is primarily interested in the type and quality of the crude, and the Marketing Department is primarily interested in the type and quality of the products, there was no mandatory requirement for crude produced by the Production Department to flow through the marketing outlets in the form of refined products.

Q Did or did not the company have extensive dealings with third parties by its Production Department for buying and selling and by its Refining Department and by its Marketing Department acquiring the products it sold?

A Yes, they did.

Q What other ~~outlets~~ aspects can you describe ~~as~~ of these various functional departments? You mentioned transfer values. Would you first touch on the separateness of the accounting of these functions?

A Each of these operating departments had its own

separate accounting office so that the transactions for that department could be recorded and reported and the cost analyzed and the financial results of the operations reported.

Q Now, with that background would you describe how that crude that was transferred from the E and P function to their refining function was valued and then how the product transferred from the refining function to the marketing function was valued for the purpose of interfunctional transfers?

A That probably needs a little more description of our policy for transfer prices. It was our policy that the transfer of values for products and raw materials should be based upon a competitive wholesale market price.

For example, with respect to crude oil, the crude oil produced and transferred to the Refining Department was determined by the posted prices for crude oil, and, of course, this meant that the refining paid the same price for the Humble-produced crude which would be the posted price plus the relative tariff transportation that it would pay to any other producer for crude ~~reserved~~ received at the refinery and in the case of products, products

were transferred from the Refining Department to the Marketing Department again on the basis of wholesale market prices or some alternate value.

For example, the gasoline that was transferred was valued at the wholesale competitive market prices as published in Platt's. For some products, of course, there is no readily available quoted wholesale market value or price, and in these cases the representatives of our Marketing Department and our Refinery Department with both of their knowledge of the market, knowledge of the products, negotiate with each other on an arm's length basis in an adversary position to try to negotiate the appropriàte transfer value to the best of their ability, market orientated.

Q Let me interject to ask as to the principal product lines where the greatest ~~value~~ volume was, was there or was there not a third party market that could be looked at to determine these interfunctional transfer values?

A Well, in the first place, for the product lines that did have a quoted public market price or value -- this was principally products of gasoline, distillates, heavy fuel oil. Now, in the period of time that

we are talking about, 1965 to 1968, we were selling approximately a million one hundred thousand barrels of petroleum products a day and about somewhere in the neighborhood of 85 to 90 per cent of that volume was in the products which I enumerated which did have a market price. The remaining products were products some of which there were market activities for a similar product which provided knowledge of the market on which to base negotiated prices.

Q Well, would you comment then on the valuation of these transfers between the functions as if they were single functions, separate companies --

A That was the -- really the objective of the system was to provide a basis of valuing transfers which would approximate the same results as if one separate independent company had negotiated with another separate independent company.

Q Do you want to comment on the capital budgeting of the various functions?

A This is another characteristic of the operating departments. Each of these departments prepared its own capital budget and its program for investments in their activity. They also, for each of these departments, provided their separate financial forecast which was needed to forecast their forward operations and the profitability of their forward operations.

There are other elements that I might comment on in addition to the ones that I have mentioned, that each department was responsible for the administration of all the employees assigned to that department which involved the employment, the training development, termination and the handling of employee benefits for these employees, and another

element was that each of these departments had contracts with separate labor unions and each of these department conducted its own bargaining with these unions, so that when all these elements are taken together the entire organization of each of these separate functional segments is designed to permit them to operate independently and separate from each other segment.

Q And each were set up on a self-sufficient basis?

A As I have described, they were on a self-sufficient basis, except as I had discussed yesterday, the availability of some of the Coordination and Service Departments which was provided at the corporate level. These departments were free to consult with those staff departments, if they felt it was necessary.

Q I want to go back to one point on the interfunctional transfer prices. If you compared the precision with which you are able to measure the interfunctional transfer price between E and P and refining, ~~would~~ with the precision with which you are able to measure the transfer price between refining and marketing -- which would you say is easiest to measure and most precise in its measurement?

A Well, since we have posted prices for the raw materials, moving from production to refining, and since there are some few products in the moving from refining to marketing which we have to negotiate prices, I suppose you would say that the measurement of revenues to the Production Department is a little more precise than the measurement of the revenues to the Refining Department from its transfer of products to the Marketing Department, but I believe that in either case the system that we have and we have employed it consistently throughout the years, is entirely adequate for the accounting purpose for State regulatory matters, tax matters.

Q And these accounting procedures are utilized in reporting for State tax purposes and other purposes consistently?

A Yes.

Q Would you describe some of the miscellaneous activities that each operating function performed and whether they were performed separately and independently of other operating functions?

A There were a number of other miscellaneous activities which each of these functional departments conducted separately. First, each department was responsible

for the inventories of materials and products under its jurisdiction, and responsible for inventory control measures, the proper stocking of materials, and providing adequate internal controls and records of the inventories on hand.

Second, each of the departments was responsible separately for maintaining the warehouses needed to provide storage for materials and products. Each of these departments were responsible for their own design of the warehouses, the operation of the warehouses, the decision of providing materials handling equipment, and the maintenance of that equipment, and each department maintained its own accounts receivable records and its own billing records. Each department maintained its own accounts payable records, and as such, of course, was responsible for conducting its own relationships between that department and its specific suppliers and customers.

Q Who set the credit and collection policies for each functional department?

A The credit and collection policies are really established by each operating manager. They utilize the services of the credit staffs in the Treasurer's

Department.

Q How was insurance handled by each of the departments?

A In order to minimize the cost of insurance, the company had a policy of self-insuring for risk less than 10 million dollars. However, there are cases where insurance is needed below that level because of governmental requirements, contractual requirements, or other requirements, and in these cases the operating managements of each of the companies requested and arranged to obtain the insurance that was needed for their particular operation.

Q Describe how product advertising and sales promotion programs are carried out.

A Well, I think I stated yesterday that the responsibility for advertising and the development of sales promotion programs for the marketing of the company's petroleum products was the responsibility of our Marketing Department.

Q As to any particular region or area, and specifically as to any state, can you give us maybe an example of how this might be implemented?

A Yes, each region office in the field organization of the Marketing Department on its staff there was a regional advertising manager, and he was responsible

for implementing the advertising program and developing the sales promotion programsthat were appropriate for his particular geographic area.

Q Now the respondent has presented and we have agreed to the admission of Exhibit 19 which has four parts, and which are photocopies of pages of the Milwaukee Journal, one coming from each of the four years in issue, 1965 through 1968, and I would like you to look at these four newspaper pages and describe to the best of your knowledge how these ads may have come about and who was responsible for them, who implemented the program?

A I have examined these photocopies. Would you please restate your question?

(Question read)

A First, it is important to recognize, I think, that each of these four ads is what our marketing people refer to as a traffic builder. A traffic builder, of course, is designed to promote the sale of products in the local area in which the promotion or the ad is run. It is clear also from these ads that each of these four ads were a part of the Marketing Department's advertising and sales promotion

effort.

Now as to how they were actually designed and used in this particular case, it would be -- it would have been the function of the advertising manager at the Central Region Office in Chicago to design these ads and to arrange for their preparation and placement in the newspaper. It is also noticed here that one of these ads is an ad for the promotion involving tickets to the Green Bay Packers football game. This indicates, of course, that this was an ad designed specifically for the Wisconsin market and it was the -- the ad itself was conceived and requested and arranged by the district manager of Humble in Milwaukee, and he arranged with the advertising manager in Chicago to get this particular ad developed.

MR. MORRIS: On the record.

BY MR. RAGATZ:

Q Mr. Luper, I believe your last response related to the ad which is exhibit 19-C relating to the Green Bay Packers. Would you further indicate or point out what indications there are in this ad that was directed to the Milwaukee area?

A Well, right in the headline refers to the Milwaukee area. It says "Enter the Enco Packer Sweepsteaks in the Milwaukee area". Second, there is indication here that the signs were provided at the participating dealers in this promotion to indicate that that service station, that dealer, was participating and the tickets for this sweepsteaks could be obtained at that station. And this little notice here says "Win the Green Bay Packers", again an indication that it was intended for the Milwaukee and Wisconsin area.

Q Would the Milwaukee district manager have initiated that particular ad?

A I think I said that it is my understanding he did initiate this ad.

Q Would you describe the other two ads, 19-B and 19-D that relate to or that use premiums?

A Well, these two ads, one ad uses a spice set as the sales promotion merchandise and the other ad uses a glassware as a promotion merchandise.

Now it would have been normal procedure for these two ads to have the design by the staff of the regional advertising manager in Chicago and he would have provided for the preparation of the ads and their insertion. However, in promotions of this kind there are usually a number of promotions available and the district manager in this case, the district manager in Milwaukee, undoubtedly reviewed all of the sales promotions available to him and selected these two particular promotions as ones that he thought would be attractive and appropriate in his marketing area.

Q Can you compare the process of the district manager requesting an ad and then selecting the ad with the procedure that might be followed had he gone to an independent advertising agency?

A Well, the advertising staff of the marketing department causes to be created in each year a number of sales promotions. And then these become available for implementation in the field organization, and the material is made available to the regional advertising

manager.

He, of course, sees to it that the district managers know what is available and the district manager then has the opportunity to decide what he thinks would be attractive and appropriate for his marketing area. And then he requests the central region advertising manager to have these ads prepared and inserted. When that's been done and agreed upon with the central region advertising manager, then he would arrange for the reproduction through our outside advertising agencies.

Q So much of his service would be like that of an outside agency?

A Oh yes, it is.

Q And the cost of running of the ad would be --

A It would be a part of the advertising expense of the central region and the regional office.

Q Charged to Wisconsin?

A Charged to the central region in Chicago.

Q But then allocated to Wisconsin?

A No, no.

Q Well, another witness will discuss the mechanics of that, but in the overall accounting of that kind of an expense it is allocated back to Wisconsin, isn't

it?

A It is my understanding that this expense is charged to the expense of the region office. If I am mistaken, another witness can correct me on that.

Q Now these ads use the name "Enco" but that name wasn't in use all over the country by Humble, was it?

A No, it was not.

Q Before when we were talking about the activities of the functions, I think I neglected to ask you whether, in summarizing, you could say that these functional departments were in competition with each other as to capital requirements as well as prices and profits?

A Yes. Since our corporate management evaluated each of these functional segments on the basis of their profitability, that placed them in competition with each of the other operating segments. And this was, of course, an important factor in their competing for the available fund for investments and the projects within their functional segment.

(Exhibit 21 marked for identification)

Q I show you what has been marked Exhibit 21 and ask you to identify what that is.

A This exhibit is entitled "Humble Oil and Refining

Company, Oil and Gas Operations and Refinery Locations, 1960 to 1963". It reflects the geographical activities for oil and gas and refinery operations.

Q Was this exhibit prepared at your direction?

A Yes, it was.

MR. RAGATZ: I would like to move the admission of Exhibit 21.

MR. SHAPIRO: No objection.

MR. MORRIS: Exhibit 21 is received.

BY MR. RAGATZ:

Q Would you describe the geographical aspect of Humble's operations?

A Perhaps I should begin with the crude production activities of the production department.

On this Exhibit 21 the areas or the states where crude was produced by Humble is indicated by the areas colored in gray. In addition, the states in which Humble produced gas is indicated by the cross-hatching. The locations of refineries are located by the symbols on the maps with the names of the locations in which they existed.

Q How was the exploration department geographically organized?

A The character of Humble-wide operations,of course, required each of the operating segments of the company to have to conduct its own field activities and each of the departments had its own field of organization, the geographical areas covered by each department.

Q Now, just generally I am wondering if the Exploration Department has decentralized offices?

A Yes, they do. They have six division offices which operate on a decentralized basis.

Q I assume these are geographically related to the areas of exploration activities?

A Yes, these activities, the field activities are located at the areas where the deposits have either been found or are prospective.

Q How about the production department?

A The production department also has six division offices located in the principal producing areas. These offices are also operated on a decentralized basis to the extent that it is economically feasible and practical to do so.

Q Describe the Marketing Department's geographical

organization.

A The marketing department's field activities, of course, were concentrated in the areas, in the market areas where they have the most concentrated population and in the industrial areas, and their field organization consists of seven region offices, and, of course, each of these region offices had a number of district offices which reported administratively to it.

I should have said also that the production department also maintains district offices which reported to the division office.

Q And how is the refining department geographically organized?

A The refining department, its field activities, of course, are conducted at the location of the refineries, and at each refinery there is the management's technical and administrative staff that is required for profitable and safe and efficient operation of that refinery.

Q And the Marine Department?

A The Marine Department has its field activities conducted from six branch offices located at the principal ports of call.

Q Now, where were the marketing efforts concentrated during the years here in issue?

A Where were the marketing efforts concentrated?

Q Yes.

A They were concentrated in most of the states of the United States, but concentrated, I would say, primarily on the eastern seaboard and the gulf coast area.

Q Do you have other than the marketing office in the State of Wisconsin?

A Yes, we have a district office in Milwaukee. Is that your question?

Q That district office is the one that directs the operations of the Wisconsin marketing department?

A The district office in Milwaukee directs the marketing activities in Wisconsin.

Q And there are no other offices in Wisconsin?

A No.

Q Now, you mentioned the concentration of marketing was in the eastern areas. Would you explain the difference between a mature marketing area and an expansion area?

A That is a term which we use to indicate the extent of development of a marketing operation. We think

of the mature areas as being areas where we have been in business for a large number of years and have become well established and the brand name is largely recognized and we obtained an acceptable position in the marketplace.

The expansion areas is the term that we use for areas where we are making a new entry into a new market. It is an area where it is a new effort. We are not widely known. We have limited facilities and it requires additional investment over long periods of time to achieve the market position that would be acceptable as a mature market.

Q Which of these categories does the Wisconsin marketing area fall into?

A It would be an expansion area market.

Q Now, organizational-wise where does the Wisconsin marketing district fit it?

A The district office in Milwaukee reported administratively to that marketing region, central region office for Chicago, and in turn that region office was administratively responsible to the headquarters marketing department or the marketing department in Houston.

Q Did this Wisconsin district marketing office have any reporting responsibilities to other functions such as the refining department or the exploration and production department?

A No.

Q How would you characterize the results of your operations in Wisconsin during the 1960's?

A The results of the operations in the 1960's were very unsatisfactory from a point of view of profitability in relation to the sizeable investment we had in Wisconsin. As a matter of fact, on an accumulated basis we had only a loss in these years in Wisconsin and that required us, of course, to consider what alternatives we had for future operations in Wisconsin.

In 1970 it became necessary for Humble to consider disinvestment in Wisconsin. However, before we could develop and implement a viable disposable plan, the Federal Energy Administration instituted product allocation controls and, of course, this prevented us from changing the nature of our operation in Wisconsin.

However, since there was no necessity for us to continue the Wisconsin operation, we chose

not to change the brand name from Enco to Exxon when we adopted that new brand name back in the beginning of 1973.

Q I think the Commission might be interested in expanding on the name change a little bit, describing the rationale company-wide for changing the name, considering the problems and the cost involved.

A Well, I think that our problem with the brand name probably was well publicized over the years at the time the Standard Oil Company of New Jersey merged several domestic companies of the United States into the Humble Oil and Refining Company, we had several brand names; a brand name for each of six or seven companies, and, of course, from an operating point of view with customers traveling around the country that was very unsatisfactory so it became evident that we needed to reduce the number of brand names we had. So at that time we adopted a new brand name, Enco, and we continued from that point on using the Esso brand in all the locations where we had normally used it, and that was primarily on the eastern seaboard,. north eastern, and we used Enco in the remaining markets in the United States, but as time went on there was a considerable confusion

in the minds of our shareholders and in our customers. We had the name of Standard Oil Company of New Jersey, which was the parent company, and the customers and shareholders were confusing that name with other petroleum companies which had the name of Standard in them. That was a problem to us. There was not any great understanding among our customers of the relationship between Standard Oil of New Jersey and Humble Oil and Refining Company so out of this grew a desire of the company to try to simplify it by giving a corporate name and a brand name which were identical.

We were confronted, however, with what that new single brand name might be. Obviously we had a great investment in the name of Esso and we would have liked to use that nationwide, but judicial proceedings determined that we were not going to be able to do that so this meant that we would never be able to use Esso nationwide so for that reason we decided we would go to a single brand name.

The name of Exxon was created and the parent company, Standard Oil of New Jersey, changed its name to the Exxon Corporation, and when Humble

Oil and Refining Company -- when that company was merged into the new Exxon Corporation, its name was changed, as I said yesterday, to the Exxon Company, USA.

And so we did change our brand name then almost every place in the United States to Exxon except in a few states where we had an expansion effort and the future was clouded just as to what the activity would be so we decided we would not change the brand name in the states, just as in Wisconsin, until that decision could be made.

Q I take it that there was some expense involved in the areas where you did change the name?

A Yes, there was some expense.

Q You characterize the results of your Wisconsin operations during the 1960's as unsatisfactory. To what do you attribute these results?

A Well, the marketing department did not achieve the results they expected primarily because they did not obtain the volume growth that was anticipated, and then this with the attendant high unit cost and the cost of entering into a new area and in an area at a time when prices were weak, the anticipated profits just did not materialize.

Q When you say "prices were weak" did the circumstances which are commonly known as a price war have any impact on that situation?

A That is a common expression for a market which has weak prices, yes.

Q When you go into an expansion area and you go into an expansion program, what does that do to the overhead of the operations during the time that you are expanding volume?

A Well, of course, when it is decided to go into a new market area, it takes a complete market staff. It is a very difficult marketing assignment so it takes a complete staff, and the cost associated, the overhead cost associated with that staff has to be absorbed by that particular geographical area, and it comes at a time before the volumes had grown to what is desired; so, therefore, it results in a very high unit cost.

Q When you go into an expansion area what kind of time period do you usually allow to implement the program and see that through to its success?

A Well, it is a long, long period. It first takes a considerable period to decide to make such an entry into a new market. Once that decision is made, a

considerable investment is required to get an initial foothold in the market and then continued investment and good operations is needed for a number of years before you could expect to come to the objective that you might have success in the beginning. It's commonly recognized that even a service station with a developed or mature market takes as much as three years after it's built for it to reach a degree of capacity that you expect for it to have.

Q During the 60's while you were in this expansion program was there any necessity from a company-wide standpoint that you had to continue to maintain the Wisconsin marketing operation?

A No, there was not.

Q Does that apply during the period 1965 to 1968?

A Yes, it did.

Q In other words, you were not dependent upon that sales outlet for disposing the product?

A Neither the company nor the marketing department was dependent on that Wisconsin operation. As a matter of fact, I believe that during ~~the/net~~ that period of time, the volume of petroleum products sold in Wisconsin was something less than one percent of Humble's total product sales.

Q I refer you again to Exhibit 21 and ask you to point out whether or not there were any exploration or production or any refining activities conducted in the State of Wisconsin?

A In the period indicated there were no operations of the Exploration and Production Departments and the Refining Department in the State of Wisconsin.

(Exhibit 22 marked for identification)

Q I show you what has been marked Exhibit 22 and ask you to identify what that represents?

A Exhibit 22 is entitled "COMPANIES ENGAGED IN ONE OR MORE COMPETITIVE OPERATIONS OF THE PETROLEUM INDUSTRY."

Q Was this document prepared under your direction?

A Yes, it was.

Q And what was the purpose of its preparation?

A The purpose was to indicate a representative list of companies which engage in one or more of the segments of the petroleum business.

Q As examples?

A Well, as an example, the first section of this exhibit is entitled "Companies with Exploration and Production, Refining and Marketing Operations." These are

companies that engage in most of the principal segments of the industry.

Q Your company would fall into this category, I take it?

A Yes, it would.

Q What is the second category?

A The second category is a listing of companies with primarily exploration and production operations.

Q Just to contrast these two categories, the second category of "companies" would be just engaged in what we have today in this proceeding referred to as your E and P function?

A Yes, that's correct.

Q Do you want to give for the record indications of companies involved in the Category I, that is all three of the major functions?

A Yes, the representative list of companies listed in Category I is, as shown here, Murphy Oil Corporation, Skelly Oil Company, Standard Oil Company of Indiana, Texaco, Incorporated, Union Oil Company of California, and I guess I could have listed many others such as Gulf or Continental Oil or other similar companies.

MR. MORRIS: Mr. Ragatz, Exhibit 22, does this pertain to the State of Wisconsin

only or other states?

MR. RAGATZ: This is the industry itself.

MR. MORRIS: Total industry?

MR. RAGATZ: Total industry in the United States.

BY MR. RAGATZ:

Q Mr. Luper, just as background, how many independent competing companies are there in the industry in the United States?

A It has been estimated there are more than 40,000 independent competing companies in the petroleum industry in the United States.

Q That would include companies with all of the basic functions as well as companies having one or more of the basic functions, I take it?

A Yes.

Q Would you describe and indicate for the record examples of companies primarily engaged in the exploration and production function?

A Yes. The companies listed here on this exhibit under Category II are the Aztec Oil and Gas Company, General American Oil Company of Texas, General Crude Oil Company, Louisiana Land and Exploration

Company, Superior Oil Company, and of course there are many others, for example, like Placid Oil in Dallas.

Q Describe the third category shown on that exhibit.

A The third category of companies shown on Exhibit 22 are companies with primarily refining operations. Included in this group are the Edgington Oil Company, Rock Island Refining Corporation, Sunland Refining Company, Texas City Refining, and the U. S. Oil and Refining Company.

Q And describe Category IV, if you would.

A Category IV is entitled "Companies with Primarily Refining and Marketing Operations," and listed in this category are representative companies such as Beacon Oil Company, Caribou Four Corners Oil Company, Little American Refining Company, Powerine Oil Company, and United Refining Company.

Q And Category V?

A In Category V is a representative list of companies with primarily marketing operations, and this list includes the East Coast Oil Corporation, Hudson Oil Company, Inc., Martin Oil Service Company, Inc., Sigmor Corporation, and Star Service and Petroleum Company.

Q Where did you compile this set of examples from? What kind of information did you use?

A The source of the names -- the companies listed on Exhibit 22 were taken from the Dun & Bradstreet Million Dollar Directory 1974. Each company is classified on the basis of its standard industrial classification number prescribed by the United States Office of Management and Budget.

Q I take it that these are just samples, and, for instance, as to the E and P function, that there would be thousands of other possible examples that could have been added to Category II on this list?

A At least thousands, yes.

Q Would the same be true of marketers?

A Yes, it would be.

Q Could you describe now and relate to your policy of functional profitability how the various categories of companies shown on this exhibit compete with your various functions?

A Yes. The individual and separate operating functions that I have described for Humble were in competition with the kinds of the companies that I have indicated on this Exhibit 22.

Q For example, your exploration and production function

is competing with the companies in Category II?

A Yes, that is correct.

Q And your marketing function would be competing with companies in Category V?

A Yes.

MR. RAGATZ: I would like to move the admission of Exhibit 22.

MR. SHAPIRO: No objection.

MR. MORRIS: Exhibit 22 is received.

BY MR. RAGATZ:

Q Mr. Luper, now that you have described the overall structure and organization of the company, would you give the reasons for why you have the separate operating departments organized under one corporate entity?

A There are a number of reasons, I think, why there is -- why the individual separate operating functions are combined under one single corporate entity.

Some of the reasons for this -- first, the petroleum -- in any industry which is highly capital intensive, such as the petroleum industry, the fixed operating costs are highly relative to total operating costs, and for this reason the profitability of such an industry is very sensitive

and directly related to the full utilization of the capacity of the facilities.

So, in the case of the petroleum industry it is -- where you have high capital investments in refineries, the existence of an assured supply of raw materials and crude is important and the assured and stable outlet for products is important, and therefore when there are -- when these segments are under a single corporate entity, it provides for some assurance that the risk of disruptions in refining operations are minimized due to supply and demand imbalances that may occur from time to time.

Q How does the combination of these separate functional departments under one corporate entity affect the profits stability of the company?

A Here again the placing individual segments under one corporate entity does provide greater profits stability for the reason that the factors which nonparallel and nonmutual economic factors which may affect one department may be offset by the factors existing in another department. And this produces a greater opportunity for profits stability.

Q Is this what the economists sometimes refer to as a risk offset?

A Yes.

Q In terms of risk, perhaps you could explain the nature of the relative risks involved in the different functional operations.

A Well, here again the combination of the individual segments under one corporate entity does reduce the impact of risk. The operations of the exploration and production department have a very high degree of risk, and much higher than other types of industrial activity. So when this type of operation is combined under an entity with other operations with less risk, it provides a diversification

and gives some protection against the risk hazard.

Q Do any other reasons come to mind for the use of a single corporate entity combining the separate operating functions?

A Yes, yes. Again, but putting the individual segments under one corporate entity provides an opportunity to provide a corporate staff, corporate staff services such as I described earlier in my testimony that enables the entities to attract high quality of staff employees. The cost and economics are obtained because the more efficient and effective use of these staff groups when they are made available on a corporate-wide basis.

Q You have now described the organizational structure of the entire company and given certain explanations as to various aspects of it including some of the company's policies of management, policies of organization. Were these policies and this basic organization in effect during the years that are in issue in this audit?

A Yes. During the years at issue the fundamental management philosophy of the company and its basic organization which involved the independent operating functions, there was no change in these during the

period that we have been discussing.

Q And would that include the period 1960 through 1964 as well as 1965 through 1968?

A Yes.

MR. RAGATZ: I have no further question.

MR. MORRIS: At this time we will take a five-minute break.

(Recess taken at 11:18 a.m.)

MR. MORRIS: On the record.

MR. SHAPIRO: Shall I proceed?

CROSS-EXAMINATION

BY MR. SHAPIRO:

Q Mr. Luper, your office is located in Houston, is it not?

A Yes, it is.

Q And in what building; is it the Headquarters building of Humble where your office is located?

A You are speaking of the time during 1960 to '65 -- 68?

Q We are relating basically to the years in issue, yes.

A Yes. That was the headquarters for the Humble Oil and Refining Company.

Q Can you describe generally how large that building is?

A Well, that building is 44 stories high and at that time the company was occupying perhaps two-thirds of the space.

Q Was the company occupying other buildings in Houston in addition to that?

A We had a research center there at that time.

Q And how large a building generally was that?

A I really don't know the size of the building. It was a four-story building I believe.

Q And was that research center directed primarily at a given function of your company?

A It was engaged entirely in the research for exploration and production activities.

Q And how many employees were located in the 44-story building that you described?

A At that time? I really don't know the answer.

Q Can you give an approximation?

A Let's say between 2500 and 3000.

Q There is, no doubt, a detailed organizational chart showing the activities of the personnel located in that building, is there not?

A I am sure there are.

MR. SHAPIRO: If it please the Commission, I would like to request that such a chart

be produced for the record pursuant to the full disclosure requirement.

MR. MORRIS: Is the chart available?

MR. RAGATZ: This is the first time anybody ever asked for one. No, there is not one here..

MR. MORRIS: Is there a possibility to produce a chart during the pendency of this action?

MR. RAGATZ: Well, certainly not today.

MR. MORRIS: I would suggest that counsel take this up during the noon hour and see if one is possible. I will take motion under advisement at this time and make a ruling at a later time.

You may proceed, Mr. Shapiro.

MR. RAGATZ: I might just say for the record on that subject that what I understood him to have asked for was a chart of the people in that building; and I seriously doubt that there are such charts in existence. But we could find out.

MR. MORRIS: The reason I reserved a ruling is for after we come back from lunch,

if it is impossible you can't produce it, put it on the record then. But I would suggest that you explore that possibility during the lunch period and I will reserve a ruling.

MR. SHAPIRO: I would like to submit, Mr. Commissioner, that such information will be helpful in this Commission's determination of the fundamental issue in this case.

MR. MORRIS: I will take the question up at 1:30.

MR. SHAPIRO: Yes.

BY MR. SHAPIRO:

Q Mr. Luper, are you a participant in a stock-option plan?

A Yes, I am.

Q So that in addition to your salary, benefits may accrue to you as a result of the overall profitability of the company by virtue of this stock option plan, isn't that true?

A I don't know about the profitability. If the price of the stock increases, I would benefit by it.

Q And are you a participant in a bonus plan?

A Yes, I am.

Q Then is the bonus associated with the profitability of the company?

A The maximum amount of the bonuses that may be paid is associated with the profitability of the company. I don't believe the maximum has ever been reached.

Q But there is that relationship. Humble's gasoline is marketed, and again we are relating to the years in issue,through approximately 29,000 service station outlets in the United States, isn't that correct?

A That is in the proper range.

Q The operations extend into some 47 states, isn't that correct?

A I am not positive whether it was 47 --

Q In that range though.

A -- or not, but somewhere between 43 and 47 perhaps.

Q Isn't it true that about one-half or just under one-half of these service stations are owned by the company and leased to dealers?

A Again, I don't know the exact percentage, but there are a large number of stations owned and leased to independent dealers.

Q And with respect to the other service stations, approximately one-half or 15,000, what type of arrangement do you operate these through which

the gasoline is sold?

A Are you speaking about those stations which the company does not own?

Q Yes, sir.

A Those stations are operated by independent merchants as a separate business.

Q And of this entire group of stations that I referred to, about 3,600 are operated by the company through company employees, isn't that correct?

A They were -- Again, I can't verify the number that you specify. But there were a number of stations that were operated by managers. We did not consider them employees.

Q Did you have companies operated by employees?

A Do we have stations?

Q I am sorry -- stations operated by employees?

A We had a few stations, relatively few stations operated by company employees.

Q And the others are operated by dealers?

A Yes.

Q Of these 29,000 or in that category of stations, do you know how many are supplied directly by the company?

A You are carrying me into the detailed marketing

operation which I am really not qualified to tell you.

Q I thought I recall from your testimony that at one point in your career you were manager of the marketing--

A Of a region.

Q -- of a region. But then it's safe to say, is it not, that a very substantial number of these stations were supplied directly by the company?

A Yes.

Q And the others were supplied by jobbers and other resellers?

A Yes.

Q Is it true, Mr. Luper, that the company sales are classified as between the motorist consumer, industrial and government by some 85 per cent branded ~~granted~~ outlets and 10 per cent at wholesale and 5 per cent to the government?

A I just don't know the answer to that question.

Q Does it seem to be a reasonable percentage breakdown?

A I would not want to express an opinion.

Q And is it true that in your company marketing operations there are some 12,000 service station employees, bulk plant and terminal employees, drivers and so forth?

A Again I cannot verify that figure, that number.

MR. SHAPIRO: I would request that the reporter take note that under the full disclosure requirement, the respondents will request that that information be supplied for the record.

MR. RAGATZ: I would like to be heard on that.

I am sure that counsel for respondent can ask a thousand questions that no one person in an executive capacity in a company

of this size could answer in full ~~disclosure~~ and that every time he thinks of a question that the witness doesn't happen to know the answer to, we will be here for months, and we are going to be sending things back and forth to Houston for months to look for it.

This is the senior vice-president of the company. He is here to testify to the best of his knowledge, and my position is that this is all that full disclosure requires.

MR. SHAPIRO: The issue in this case is a very fundamental one and it touches upon all the operations of the company. We submit that the information that is required is extremely important to the Commission so that it can make an intelligent evaluation and determination of the issue.

MR. MORRIS: Mr. Ragatz?

MR. RAGATZ: Mr. Chairman, I would like to point out further that the testimony has already indicated that

representatives of the respondent collectively spent a couple of months in Houston for the purpose of asking this client questions, and if the respondent doesn't have the answers to these kinds of questions now and hasn't asked me or someone else from Humble in advance of trial, I don't think you can fault Humble people or fault us for not having the information at this time.

There was no request by respondent for discovery. There was no request to me to provide an organizational chart of some nature, I don't think, so how we can hold up these proceedings and make these kinds of requests at this time -- after all, the respondent had the initial opportunity to audit and did audit extensively. People spent weeks down in Houston. I don't see how we can now use the full disclosure statute to hold up the proceedings on this case because there are certain questions that counsel can think of that we don't readily have the answer for.

MR. MORRIS: Mr. Shapiro?

MR. SHAPIRO: This ~~was~~ is a hearing under oath and before the Tax Appeals Commission, and 71.~~10~~ 12 (3) of our statute requires full disclosure by the taxpayer under oath at the hearing before the Tax Appeals Commission.

MR. MORRIS: Mr. Shapiro, I think in this case, this is a basic case set forth in the new concept. If you had as much time down in Houston and you had as much time for discovery as Mr. Ragatz, why wasn't this discovered prior to this hearing?

MR. SHAPIRO: The auditors may not be prepared to make an extensive examination that is required in a hearing in Houston.

MR. MORRIS: The question of the charts and/or development of the company as requested by yourself at this time are the kind of questions that are basic or primary to this case. Why weren't they asked during the period where discovery was available to you or during periods when you were auditing in Houston.

MR. SHAPIRO: Again I refer you to the express terms of the full disclosure statutes.

MR. MORRIS: Again I will get into argument with counsel about this later. We have a witness here who I would like to hear testify and I will get into argument along these lines later.

Regarding the testimony, I will say this for the Commission, the Commission here is sitting for one purpose; that is to have all the evidence available at its disposal or at its hearings. We would like this to happen, but again I have to agree with Mr. Ragatz in a way. I am not going to delay this hearing for weeks waiting for both sides to go back and forth and try to discover things.

MR. SHAPIRO: We are not asking for weeks of delay.

MR. MORRIS: I will take this up at 1:30 with counsel on both sides.

Again, this witness is here to testify to the best of his knowledge and ability,

and at this time I would have to say he is.

As to the material and information he does not have, I will take this up with counsel at 1:30. You may continue.

BY MR. SHAPIRO:

Q Mr. Luper, is it not true that about 77 per cent of the gasoline marketed by your company comes from Humble refineries?

A I just cannot verify that question.

Q And of the remainder what percentage would come from exchanges?

A I do not know.

Q You have testified that the Enco brand is used and has been used. In how many states was the Enco brand used?

A I believe in the states in which we have marketing operations, but the Enco brand was used in all these states except in the range of 13 to 15 states, something of that order.

Q I would like to refer back to my previous question for a moment. The gasoline marketed by your company comes primarily from two sources, doesn't it, from Humble refineries and from exchanges?

A Yes, I think that is true.

Q And a very small percentage, less than 1 per cent, comes from purchases, isn't that true?

A I couldn't verify the latter statement. I do not know.

Q In marketing Humble gasoline is importance placed on such factors as hours of operation of the service station, appearance, availability of credit, confidence in the product quality, quality of services, and price?

A Mr. Counsel, naturally I have a general knowledge of these matters, but here again you are asking questions directly involved in the marketing policies and procedures of the Marketing Department which I am not very closely associated with.

MR. SHAPIRO: May I ask Counsel whether one of his witnesses will be more closely associated with marketing-type activities of the company?

MR. RAGATZ: I think the answer is no.

MR. SHAPIRO: Can we proceed?

MR. MORRIS: You may proceed.

THE WITNESS: If you would like for

me to give you a general response to
your question, I will be glad to do so.

BY MR. SHAPIRO:

Q In marketing Humble's gasoline, is importance placed on factors relating to the retail outlets such as hours of operation, appearance, availability of credit, confidence in product quality, quality of service and price?

A All of these things that you mentioned are of interest to our customers and consumers, and I am sure that they are considered an important element in our marketing operations.

Q Certain characteristics of gasoline affect the performance of an automobile, isn't that true?

A Again I am not qualified from an engineering point of view to comment on that, but, of course, it is well known or well said to be true.

Q For example, starting and warm-up and vapor lock are controlled by the hydrocarbon composition of the gasoline?

A I am not qualified to answer that question.

Q In 1967 did your company develop a carburetor detergent additive to reduce maintenance and operating costs?

A I do not know.

Q Are you familiar with the additives developed by your company?

A Only from the mere fact that we do have additives. I am not familiar with the additives.

Q And these additives have some effect in eliminating emission pollution, do they not?

A Again I cannot answer that from direct knowledge.

Q Are you familiar with the additive ~~HPA~~ HTA?

A I have heard the additive name, yes.

Q Was that developed during the period in issue?

A I really don't recall.

Q But it might have been?

A It might have been.

Q Are additives that are developed by Humble made available to other oil companies?
A I do not know.
Q Are the additives patented?
A I assume that they are.
Q Are these formulas known only to your company?
A I do not know.
Q Is that your impression that they would be?
A I have no impression about it on that point.
Q Is a significant part of research and development devoted to improving the quality of gasoline?
A Yes.
Q How much money is spent annually on such research and development by Humble?
A I haven't done enough preparation in this line to be able to tell you.
Q Isn't it true that an automobile gets better mileage with a heavier gasoline?
A I do not know.

MR. SHAPIRO: I ask, Counsel, do you have a witness that is more familiar with the quality of the product?

MR. RAGATZ: We have a couple of witnesses that have engineering backgrounds,

but I am not aware of what their knowledge is on the type of questions you are asking. You will have to just wait and ask the question.

BY MR. SHAPIRO:

Q Mr. Luper, the blending process in your refineries is accomplished with the aid of computers, is it not?

A I understand that to be the case.

Q And the refinery is an extremely complex and highly automated process, is it not?

A Yes, it is.

Q Could you explain what is meant by "blending"?

A Not from a technical point of view, I could not.

Q But from another point of view, a layman's point of view?

A I really would not want to attempt that one. I don't know enough about that to express an informed opinion about it.

Q Are seasonal variations taken into account, that is a different gasoline is manufactured for winter than that manufactured for summer, isn't that true?

A I understand that that is true.

Q And are finer variations accounted for, for example,

when the company is marketing gasoline in Illinois or Wisconsin where seasonal changes in temperature occur fairly rapidly, does the time lag in delivery from a refinery to a service station cause problems at times?

A Counsel, you are getting into an area which I am not just that intimately familiar with. I can't answer that question.

Q Is it true that there must be a great deal of planning to compensate for these changes in temperature?

A I am sure there is a great deal of planning involved in the proper distribution of the petroleum products.

Q And what geographic areas that differ with altitudes, humidity and so forth, they require a different blend of gasoline -- for example, San Francisco and Reno, Nevada --

A Well, I don't know that from direct knowledge. I understand that the differences in altitude can make a difference.

Q Would the gasoline manufactured for a 1950 model automobile work satisfactorily in a 1968 model?

A I really couldn't tell you.

Q Do you know whether octane ratings increased during this period?

A During --

Q During the period in issue?

A I think it is -- to answer you specifically -- I do not have that information. It is again my impression that during this period of time the octane rating within the industry did have a tendency to increase due primarily to the changes in the automobile engines.

Q And this resulted from a variety of complex and costly refining processes, did it not?

A I am certain that changes were required, but again I cannot give you the specific information about it.

Q Is the gasoline produced by one of Humble's refineries the same chemical mixture as that made by another company before the additive is put in?

A I am not qualified -- I am not a chemical engineer and I cannot answer that question.

Q Your operations include the purchase of land and construction of service stations, isn't that correct?

A Yes, it is.

~~Q Is this accomplished by a particular segment of the company?~~

~~A Yes, it is.~~

Q Is this accomplished by a particular segment of the company?
A Yes, it is.
Q And what segment is that?
A What segment is it?
Q Yes, sir.
A The segment that purchases land for service stations is the marketing function, the Marketing Department, and it is done by their field organization in the field location, the regional offices.
Q And what officer or employee in the company has the top responsibility for that type of activity?
A Well, the overall responsibility rests, of course, with the vice-president in charge of marketing, the head of the Marketing Department, but of course he delegates that authority to make purchases in accordance with the Department's budget to various individuals in the field locations.
Q And the vice-president in charge of marketing is headquartered at Houston?
A Yes, in the Marketing Department at Houston.
Q Now these stations that are constructed are made to sell your brand of gasoline, are they not?
A Yes.

Q Is the income that is received by the company in the form of rent, does that income alone constitute a reasonable rate of return on the investment?

A I have just not made a study of that. That again is in the area of the financial analysis of the Marketing Department.

Q I understood you were one of the top financial managers of the company?

A I was the manager in the central region, yes. The rents, it was -- it was our policy to try to establish rents which represented a reasonable return on the investment.

Q But in addition to that station, I think you pointed this out in your previous testimony, it would benefit your company by providing an outlet for the product, isn't that correct?

A Yes.

Q So that when you look at the rental received and the degree of assurance of an outlet, these two factors make a reasonable return as a combination, do they not?

A Well, we do not consider on a combined basis.

Q But there are the two factors involved?

A One factor is the rent associated with the real

estate investment and another factor is the margin associated with the sale of petroleum products.

Q Is the assurance of a retail outlet important to the company in terms of being able to construct the kind of refinery and distribution system that you need?

A Would you please repeat that?

(Question read)

A Well, I would say that the construction of the refinery -- the thing that is considered there is the type and quality of the crude that is going to be available to that refinery. With respect to the service station, as I have said before, the existence of a stable and assured market outlet is directly related to the refinery investment.

Q During the period in issue, the refinery that is indicated on Exhibit 21, the map, as Benicia, California, was that during this period in the process of being constructed?

A It was in the process of being constructed in part of these years, yes.

Q Now wasn't a principal motivation for the establishment and construction of that refinery the market

for automotive products in California -- in California plus neighboring, some four neighboring states?

A Well, a motivation was to have a product, a source of product supply for all of the sales requirements that we might have in those areas.

Q Isn't it true that during that period the number of vehicles was growing very rapidly, seven to ten per cent a year in the California area?

A I can't verify the percentage, but California was a rapidly-growing gasoline market.

MR. MORRIS: Gentlemen, we will stop there.

(Noon recess, 12:00 - 1:30 p.m.)

AFTERNOON SESSION
1:45 p.m.

MR. MORRIS: Let the record note that a conference was held with this Commission, with counsel for the petitioner and respondent regarding the motions made and the objections thereto at this morning's session. The motions that were made by Mr. Shapiro, and objections made by Mr. Ragatz are further taken under advisement and again will be brought before this Commission on Monday afternoon at 1:30. At that time those motions will be further explored and ruled upon if necessary.

MR. RAGATZ: Mr. Chairman?

MR. MORRIS: Mr. Ragatz?

MR. RAGATZ: For the record, and just to be sure that I am clear on what we talked about and what was agreed, I have stated this morning our position as to the timeliness of the request made by Mr. Shapiro. And I would like the record clear that we feel he and the Department had every opportunity to make these requests months

ago or even during the course of their audit when they were supposed to be making those inquiries; and that we think it's unreasonable to first make these inquiries at the time of trial.

Nevertheless, to the extent that it will not slow down the process of this case and not materially inconvenience our client, we are going to try to produce a couple of documents for them. And let me state for the record what I understand to be the limit of his request.

I understand that he wants, if one exists, an organizational chart covering the headquarters building down in Houston for the period, or at least some part of the period in issue; and, secondly, he wants one or more exchange agreements covering product that came into the State of Wisconsin during the years in issue.

MR. SHAPIRO: That's correct.

MR. MORRIS: All right. And any further requests than that?

MR. SHAPIRO: No, sir.

MR. RAGATZ: One other thing that I might add, that is the timing of your taking up this motion again might require further extention in that it's doubtful that we are going to be able to get ahold of anybody over the weekend down in Houston to look these things up. So it probably will be the first of the week before the search can be made and probably impossible to get any documents up here by Monday afternoon.

MR. MORRIS: I will amend my ruling to Wednesday. I assume we will be here till Wednesday. That's an assumption I have to make.

MR. RAGATZ: I assume so too.

MR. MORRIS: Wednesday at 1:30 on October 9th.

MR. SHAPIRO: I have one modification. In the event the witness cannot supply it readily, we would request earnings on investment as between E and P, refining and marketing, the three major departments. We request that earnings on investment be

supplied.

MR. RAGATZ: That I am going to object to very strenuously. That sounds like a terrific amount of work and this is a very late date to be making that kind of a request and in this complicated proceeding.

I don't know that that information is kept in the form that it's requested and I don't think that the Department of Revenue ought to impose upon our client to put that kind of information together at this time. Had that request been submitted a month ago or six months ago, I would have deemed it more reasonable. But I deem it unreasonable at this time and I therefore object to any requirement that we produce that kind of information at this time.

MR. SHAPIRO: Could we submit that that type of statistical information would be readily available.

MR. RAGATZ: And I submit that that should have been asked for then at the

time of audit or certainly it could have been asked for in some kind of discovery proceeding, or I could have been asked to attempt to obtain it weeks or months ago. It is too late for that now.

MR. MORRIS: Gentlemen, if the arguments continue we will be here for a long period of time. And I have had a request to try to move the witnesses along and try to get through the testimony.

I would only request you to explore them, Mr. Ragatz, to see if it is available and to report back to Mr. Shapiro.

On the motions made and the objections made I will take the motions under advisement. I will allow counsel from both sides to make arguments at the time of the ruling on motions and that will be at 1:30, October 9th.

Anything else to come before me before we proceed? Hearing none, you may continue with your examination, Mr. Shapiro.

MR. SHAPIRO: Thank you.

BY MR. SHAPIRO:

Q Mr. Luper, in order to assure high quality standards and to protect the brand name or brand names, trade-mark and good will of the company, it is necessary to have the new complex manufacturing systems that are illustrated by the Benicia, California plant, isn't that true?

A The refineries in the industry all make a very good product; and I believe that the recognition given to the quality of the product, it is clear that good quality products can come from any type of refinery or most refineries.

Q Do the additives used by Humble require special equipment and methods for mixing into the gasoline?

A I just do not know that.

Q Is the additive a rather thick substance that would tend to settle at the bottom of a storage tank if it were just merely dumped in?

A I do not know.

Q And at what point in the distribution system is the additive mixed into the gasoline?

A I would be speculating on that. I know, of course, that additives are introduced at the refinery. Whether they are introduced at any other location

in the distribution system I am just not aware
of that.

Q Do you know whether the additive is packaged, is
placed in a certain type of container?

A No, I do not.

Q But it is manufactured by Humble, is it not?

A Humble does manufacture some additives.

Q And do they acquire some additives from other
parties?

A I am under the impression that we do, but, again,
I am not directly involved in that.

Q Does gasoline that is received under exchange agree-
ments include additives?

A I presume that they do.

Q The gasoline that is received from an exchange partner
is refined according to Humble's specifications,
is it not?

A Again, that's not in my area of operation but I
understand that to be the case.

Q Isn't it true that Humble adds its unique additive
to practically all of the gasoline received on
exchange?

A Again I just really can't tell you for sure about
that.

Q Are there basically two types of exchange agreements?

A I don't know really what you are referring to and it is my understanding that a subsequent witness will be able to respond more directly to the questions in this particular area.

Q Do you know whether such agreements are set forth in signed documents?

A Are set forth in what?

Q Signed documents.

A Yes, I believe they are.

Q And do these documents require compliance with certain specifications?

A I have never really seen or read one of these exchange agreements, so I can't tell you of any direct knowledge.

Q Do you know how many or which companies you have exchange agreements with during the years in issue with respect to crude oil?

A No, I don't. But a subsequent witness will have some information on this point.

Q Do you know what official of Humble would negotiate a major exchange agreement covering a large quantity of crude oil with another supplier?

A It would be the general manager of our Supply

Department or one of his assistants, delegated assistants.

Q And that official is in Houston?

A Yes.

Q Do you know what official would negotiate a major exchange agreement of finished product with another supplier?

A Again, that would be the general manager of our Supply Department.

Q The same place?

A I believe that that is true.

Q An exchange of products, whether it be crude oil or
gasoline results in an economic advantage to both
exchange partners, does it not?

A I assume that like any other contract mutually
arrived at, that each party expects to receive the
benefit from the agreements.

Q Does it accomplish ~~price~~ place utility or in other words
a savings on transportation costs?

A Yes, I think it could.

Q The net result is the same as having your own product
at the location where you want it, isn't that correct?

MR. RAGATZ: I will have to object. I think that calls for a legal conclusion that this witness is not qualified to respond to.

MR. SHAPIRO: That is not a legal conclusion.

MR. RAGATZ: What constitutes your own product title? What are you talking about?

(Last question read)

MR. MORRIS: Do you understand the question?

THE WITNESS: Yes.

MR. MORRIS: Can you answer the question?

THE WITNESS: I have my belief about it, yes.

MR. MORRIS: Well, I will allow him to answer the question based on his knowledge.

MR. SHAPIRO: I submit it is a business judgment.

MR. MORRIS: Yes, on his business judgment.

MR. SHAPIRO: Yes, sir.

MR. MORRIS: You may answer if you understand the question to the best of your knowledge and ability.

THE WITNESS: I regard an exchange agreement as a purchase and sale and an independent transaction so I would not place one in such a position with the other. I would not say they are the same.

BY MR. SHAPIRO:

Q It does accomplish the result of having the product where you want it, does it not?

A Yes, that is why the agreement was made.

Q How much initial investment was required by your retail dealers?

A Well, I couldn't give you an exact answer on that because obviously it depends on the location, the size of the station, the place where it is, the amount of facilities involved, how much inventory is being carried.

Q Well, do you assist the dealer in financing such an investment? I should say does Humble assist the dealer in financing such an investment?

A On occasions we do.

Q In what manner?

A Well, again you are carrying me into activities that I have to remember for several years, but on some occasions we can supply the equipment, loaning equipment, and in other cases we can give him credit for the purchase of products and even going further, there are times when we can even make direct loans to him.

Q Through what office is that accomplished?

A Well, that is accomplished -- initiated in the district office and it's the process of, you know, in the ordinary case that may be all we require, but

in other cases it might require the review with the Central Region Office.

Q Does it in any case require review or approval or assistance from the Houston headquarters?

A Normally I would say that if it is in the general policy that we set down, no; but obviously if the situation were peculiar or if it was an extra large amount of credit involved and the dealer had limited financial resources, whether they were an unusual risk, why it might have to -- the matter might be referred to the Marketing Department at the headquarters in Houston.

Q Does the company have standard lease forms?

A I believe they do, yes.

Q And were these drafted originally or are they drafted or revised at Houston?

A You are talking about, of course, the lease form for service stations?

Q Yes, sir.

A I really have no direct knowledge on that, but I presume like any contract, it is reviewed from time to time to keep it a modern document.

Q Would the Legal Section at Houston be responsible for that work?

A Not necessarily. The Regional Office has legal counsel, too, and it could be done there, but it also could be done in Houston.

Q Standard forms, I take it, are designed in Houston, are they not?

A I would say that most of them are.

Q Is dealer training an important activity of Humble?

A Yes, I would say it's an important activity of the Marketing Department of Humble.

Q Do you know how many training centers there are in the United States?

A No, I do not.

Q Are there any in Wisconsin?

A I do not know.

Q Do you know where any of them are located?

A You mean during the period in which we are talking about?

Q Yes.

A I am certain that there are training stations in each of the regions such as Houston, for example, and I am more familiar with Texas as I reside there, and in Abilene; maybe Fort Worth, Dallas.

Q With reference to Wisconsin, would that be Chicago, Milwaukee or Memphis?

A Well, the Regional Office for the Wisconsin area has been Chicago and Memphis. I am certain within that regional area -- I am certain there were training stations, but where they are located, I just don't happen to know.

Q Are all new dealers required to take the training course?

A I do not know that. I doubt it.

Q But some dealers from Wisconsin may go to the regional training center in order to get the benefit of that course, isn't that correct?

A I presume that's true.

Q Does Humble have a uniform credit card system?

A Humble has a uniform credit card.

Q This credit card would allow the driver to purchase gas in Wisconsin and outside Wisconsin at Enco as well as Esso brand stations, would it not?

A Yes, it would.

Q Isn't this an important marketing tool and valuable to the local dealers in the State of Wisconsin?

A I would say that it was a valuable marketing tool and it is also a value to the dealers.

Q Now, this credit card is used in all of the states in which Humble does business, isn't that true?

A Yes. I have to qualify that in one respect. I haven't actually checked this, but I assume that the credit cards in the Wisconsin area would carry -- it might carry an Enco brand name as opposed to Exxon. I am not really positive. I haven't thought to check up on that.

Q From which office is the credit card system administered?

A Well, the credit card system overall, of course, is -- if you are talking about the system -- it is the general policy --

Q Yes, sir.

A -- to carry out the credit card arrangements. These would be made by the Marketing Department in Houston, however, in implementing the system it requires, of course, some accounting and collection effort, and there are -- I have forgotten how many locations in the period we are talking about, but there were two or three accounting centers, credit card centers in that period.

Q What official in Houston is responsible for general administration?

A The vice-president of marketing.

Q To what extent does Humble design service stations

for continuity of appearance for the driver that
goes from state to state?

A Well, here again certain design features are developed
through the engineering staff in Houston in the
Marketing Department of Houston, but you must remember that across this country there is a wide variety
of terrain and a wide variety of shapes and sizes
of locations and a wide variety of zoning laws, and
so that means that in addition to some overall
criteria that might be established by the headquarters Marketing Department, the region offices
have to have a certain latitude to permit them to
use these in a way to conform to local laws and
conditions and zoning permits.

Q Do you know approximately how many people at Houston
would be involved in this activity?

A I really don't have any data to tell me what this
would be.

Q There is a considerable time lag or time lapse
between the manufacture~~r~~ and the use of gasoline,
isn't that correct?

A That's too broad a question and covers so many different locations I wouldn't know how to answer that
really.

Q If I can elaborate a little more, from the refinery to the terminal or bulk plant, it might be one to 20 days?

A Again I don't know, but I think that might be possible.

Q And an additional two to 12 days in storage?

A Again without knowing, that sounds reasonable.

Q And another two to four days to the filling station?

A Two or four days for moving it from the terminal to the filling station?

Q Yes, sir.

A I think that normally that would be done the same day.

Q And the product may be in the filling station up to eight or ten days, might it not, in some instances?

A I would think so.

Q Now this time lag between the refinery and the consumer seems to ~~be~~ involve about 30 days or more in some cases. Does this mean that the refiner must manufacture the gasoline sometime ahead of its use -- that is obvious, I think.

A Yes, I would say that is true.

MR. RAGATZ: I will stipulate to that.

Q If the weather is unusually warm or unusually cold, this may create problems in meeting consumer expectations of good driving, might it not?

A Expectations for good driving?

Q For good driving.

A I don't really understand.

Q Well, there might be problems with respect to the climatic or the extreme changes in temperature?

A If you mean that the extreme -- are you talking about gasoline?

Q Yes, sir.

A I will just have to answer your question, I really don't know.

Q Might there be another problem to overcome as a

result of this time lag, and that is to prevent the gasoline from adversely changing its characteristics during this period?

A Again, I am not technically qualified to answer that.

Q Well, I have a number of more questions along that line, but apparently you don't feel qualified to answer them.

A I am not involved at all in refinery operations, and I have no background on product quality or its processes.

Q Well, is it true that the refining and marketing functions are faced with a large number of variables as well as changing economic conditions?

A Yes, I think you could say that.

Q During the years in issue Humble experienced periods of long and short supply, isn't that true?

A I haven't made enough analysis of that to really say.

Q On the basis of retail sales estimates, can Humble plan production requirements and move production long distances, provide terminal storage, and provide local delivery with a fairly high degree of accuracy?

A Obviously the company must make operating programs for its production and distribution activities, and

these must be based, of course, on estimates of sales demand and weather and other things, but I don't know how you would define a high degree of accuracy, but obviously it is -- it is subject to variation, but I believe we do it well enough to make the immediate service to our customers.

Q Gasoline distribution includes the network of retail outlets and also the tankers, barges, pipelines, trucks and terminals that are required to move a product from refinery to the retailer, isn't that true?

A All of those facilities in one form or another are used in the distribution system.

Q Doesn't the operation of this network as well as the refineries to manufacture the gasoline, require a delicate balance of supply and demand in order to be efficient?

A Well, obviously to the extent that accurate forecasting can be made, the accuracy has a direct bearing upon the efficiency which could be expected to --

Q What services are rendered by the Houston office to further that objective?

A To further the objective of an efficient distribution

arrangement?

Q Yes.

A Well, the overall plan for the distribution of products, of course, does -- it is developed in Houston and primarily in our Supply Department as to what the requirements will be, and then those requirements are made known, of course, to the transportation facilities, and other people involved at terminals, and those people then each in their own sphere of activity have to implement that action.

Q What services are rendered by the Houston office to keep the various departments current on information?

A Would you please tell me what you mean when you say "various departments"?

Q Are there such things as daily or weekly letters or bulletins that are distributed by Houston?

A You mean within the Marketing Department?

Q Marketing and/or the Refining, yes.

A There are no weekly or no bulletins of that kind, to my knowledge.

Q Now with respect to the newspaper ads that Mr. Ragatz referred to ~~offered~~ on direct, does the "Tiger in the Tank" slogan offer an effective promotional device nation-wide for Enco and Esso?

A Yes, I believe we felt that the "Tiger in the Tank" slogan was a very effective sales promotion.

Q This is a distinctive trademark for all of Humble's gasoline which indicates a powerful gasoline, isn't that true?

A It never impressed me as being powerful, to denote the idea of a powerful gasoline.

Q Do you know where the mats were prepared for the ads, other than that relating to the Green Bay Packers, where the mats were prepared?

A I am not very familiar with the processes by which one goes from an idea to the finished product, but on the Packer ad I presume that the idea was conceived by the district manager in Milwaukee and that he transmitted that idea to the Central Advertising Department and Advertising Manager in the region office and that manager, with the help of the advertising agency, probably had either designed or had the mats prepared.

Q Where was the "Tiger" slogan conceived?

A I really don't know. This goes back before my time, I believe. I understand that the "Tiger" was used within some of the company affiliates before it became -- before it was resurrected and became

popular in the 1960's, and so I really don't know the answer to that question.

Q There is an advertising function carried out at Houston, is there not?
A As I said before, the advertising staff in Houston is a part of the Marketing Department.
Q Does Humble promote products by uniform packaging?
A Yes.
Q And brand names?
A Yes.
Q Lubes and canned oils and greases, are they branded?
A Yes.
Q What brand names?
A We use, again, the brand name Exxon and we use the brand name Uniflow. We may have others.
Q But during this period was it probably Uniflow?
A During this period, of course, we did not use Exxon. We used Uniflow. We used Enco and we used Esso. Those three I am sure we used.
Q And those products were sold throughout the United States?
A Well, the Enco products were sold in the areas where we had the Enco brand; and the Esso brand had products sold in the area where we used the Esso brand.
Q Is promotional display equipment -- let me rephrase that.

Where would promotional display equipment be designed and manufactured?

A I believe that the equipment would be designed primarily by the Engineering Department, engineering staff of the headquarters marketing. That would not rule out, of course, the engineering staff at the region levels to also have constructed equipment for the display of signs to meet their particular situations. And then you asked about the construction. They would be, of course, constructed by outside contractors.

Q Who has authority to set and adjust prices for tires, batteries and accessories?

A The vice-president of marketing has that authority and he also has the authority to delegate that authority to other managers in his organization.

Q And who has that authority with respect to gasoline?

A Again, the vice-president of marketing has that authority and he may delegate that authority to others in the Marketing Department.

Q Who has the authority to prescribe uniform selling forms or contracts?

A I will have to assume when you say "uniform" that you mean uniform for the entire marketing operation.

Q Yes, sir.

A And in those situations very likely the marketing staff and marketing legal counsel in Houston would draft that type of a uniform agreement. But that, of course, wouldn't rule out the marketing staff and the marketing legal counsel at the regional level to design a uniform agreement for the area of its operations.

Q Who has authority to prescribe guarantees or warranties on products?

A Again that would be under the responsibility of the vice-president of marketing.

Q Who has authority to prescribe the sales territories?

A You mean by that the establishment of districts?

Q Yes, sir.

A That would be the vice-president of marketing.

Q And is he also vested with the authority to establish new stations?

A Oh, yes. That doesn't mean that he is not the only one, of course.

Q Well, under certain circumstances final approval for more extensive setup of new stations would be with him, would it not?

A Well, the capital budget for each year would be

supported by a program, a building program of service stations. And when the Marketing Department had approved that program, why then, undoubtedly,the region marketing managers then would have authority to proceed to build those stations.

Q Who has the final authority to approve those budgets?

A I would say that the final authority, if you are talking about the annual budget, that was approved by the Board of Directors of Humble.

Q I take it the Board of Directors would have final authority if a large expansion of service station outlets in a given area were contemplated?

A If that expansion were in a new area or was of a sufficient magnitude, it would have been reviewed with the Board of Directors.

Q And that also would be true with respect to a contraction or withdrawal from an area, would it not?

A Again, it would depend upon the size of the area of the withdrawal and the magnitude of the investment that was involved.

Q Is there a dollar limitation on the magnitude of investment?

A Yes, there is, but I do not know what that limit was at that particular time.

Q Who has final authority to enter into long-term~~ed~~ exchange agreements for either crude or finished product with other companies?

A I think I stated before it was the general manager of our Supply Department and his delegated assistants.

Q And who has final authority to enter into contracts for the purchase of tires, batteries and accessories?

A The responsibility for deciding what is needed would be the Vice-President of Marketing. But the contract itself might be executed by our Purchasing Department.

Q Are Atlas tires sold in all Humble service stations?

A No. If you mean Humble stations defining the Humble brand, the answer would be no.

Q Enco?

A Yes, sir.

Q Is the Purchasing Department within the supply function on Exhibit 20, sir?

A Exhibits 20.

MR. MORRIS: At this time we will take a ten-minute break.

(Recess taken at 2:30 p.m.)

MR. MORRIS: Mr. Shapiro, you may proceed.

MR. SHAPIRO: Thank you.

EXAMINATION

BY MR. SHAPIRO:

Q The final authority for the purchase of tires, batteries and accessories is with the Purchasing Department I believe you have testified, is that true, sir?

A No, I did not testify that. I testified that the vice president of Marketing had the responsibility for the purchasing of tires, tubes and batteries, but he requested our purchasing office to execute the contract in the purchase for the marketing function, and, of course, the marketing function is allocated an appropriate part of this purchasing office expense to charge against the marketing function.

Q And if there is a contract executed, it is executed by the Supply Department?

A By the purchasing office.

Q And the purchasing office is in the Supply Department?

A It is a segment of the Supply Department.

Q And as we noted in reference to Exhibit 20, that is the Supply Department; that is approximately in the middle of the page?

A Yes, that's correct, one of the corporate staff services.

Q Are there contracts in existence covering Humble's needs over extended periods of time with respect to tires, batteries and accessories?

A I do not know what period this provided for in the existing contracts.

Q Who is authorized to borrow money for working capital and long-term loans?

A The treasurer has that authority, and, of course, if the amounts were sufficiently large and if it involved the undertaking by the corporation, it would have to be approved by the Board of Directors.

Q Who decides how to invest surplus funds?

A The treasurer of the company.

Q Where are the principal banking functions performed?

A We have important banking facilities in most of the large cities where we have offices. It would include Houston, Chicago, Philadelphia, New York and so forth.

Q Who would be responsible for coordinating and setting

up major policies with respect to banking?

A The policies for the company, of course, were developed by the treasurer of the company.

Q Do you know where the flow of cash from Wisconsin sales were deposited?

A I do not know specifically where the funds were deposited and the channels it went through, but normally the receipts would be deposited in local banks for transfer to other banks.

Q Transfer to other banks?

A Yes.

Q Probably outside Wisconsin?

A It could be.

Q In most instances would it be the banks outside Wisconsin?

A Yes, I would say it was.

Q What was the source of the money used for investment in Wisconsin property?

A Would you restate that question?

Q What is the source of the money used for investment in Wisconsin property?

A Well, if you are speaking about the actual funds, of course, they are provided from the corporate treasury.

Q And what money was used for the payment of wages for Wisconsin employees?

A Well, all the money that the corporation had was the corporation's money, and the corporation bank account was required by law so in that respect it was the corporation's money.

Q Do you know whether borrowed funds were used to finance investments in Wisconsin?

A I really don't know the answer to that question because the initial investment in Wisconsin was made by our parent company and not by Humble.

Q But there are instances where funds are transferred from out of the state into Wisconsin, isn't that true?

A Well, it could be. I am not aware that it was or was not.

Q Do you know for what purposes that would be?

A You mean for funds transferred in?

Q Yes, sir.

MR. RAGATZ: I believe the witness has testified here that he doesn't know. I don't know how you can put another question to him when the witness says he doesn't know whether the funds came in or not.

MR. MORRIS: Do you have an understanding of the question?

THE WITNESS: Yes, I can elaborate on that. I would suspect that any funds that came in were for local use for, you know, small purchases, petty cash. If there were any, I would say it would be for that purpose.

Q Are standardized accounting forms designed and used by Humble?

A The answer to that is yes, but, of course, each operating function also has designed standard forms for their section.

Q Are there accounting manuals in existence?

A There is -- there was an accounting manual and an accounting manual for each of the operation segments.

Q And where are these accounting manuals prepared?

A They are prepared -- with respect to the corporation manual, they would be prepared under the supervision of the comptroller of the company. As far as the accounting manuals for the separate operating functions, these manuals would probably be prepared under the supervision of the comptroller for that particular operating function. Each of the operating

functions has a comptroller on the staff.

Q What accounting reports go to Houston with respect to operations, inventories and so forth?

A Well, let me just confine my response to the Marketing Department, if I may first. The accounting activities in the Marketing Department were performed primarily at the regional level. Each region had an accounting office, and, therefore, as transactions occurred, the source documents flowed into these regional accounting offices for recording and handling. On a monthly basis the retail offices provided the comptroller of that marketing function in Houston reports so he could make a consolidated report, financial report and operating report for the marketing function, and then, of course, the marketing comptroller forwarded a comparable report, but more summarized and an abbreviated form to the comptroller of the corporation so he might prepare a consolidated report for the corporation as a whole.

Q And can you explain that procedure with respect to the other functions?

A Yes, it was substantially the same except that the accounting centers were also identical. In the Production and Exploration Department the procedure

was substantially the same as I described for the Marketing Department. For the Refining Department accounting offices were maintained at each of the principal refineries and here again they prepared the reports necessary for their local use and provided summaries periodically to that refining comptroller in Houston in the same way I described.

Q Is there a uniform~~ed~~ system of accounts established for that major department?

A Yes.

Q And who has the responsibility for the establishment of that?

A Well, as far as the accounts for the corporation as a whole, of course, the comptroller, the corporation comptroller is responsible for that, but as that moves down into the operating functions, the functional comptroller can use an accounts system that is compatible with what is required by the corporation comptroller.

Q What is the principal area on which the company draws its research and development data?

A Each of the operating functions have staff technical employees who are familiar with and are engaged in the research activities, but the actual research

itself is performed outside the Humble Oil and Refining Company. This morning we were talking about office space and I inadvertently told you that the office space research -- I left the impression that it was Humble property. It is actually owned by the Esso Products Research Company which is a separate company, a wholly-owned subsidiary at that time of Humble, and it provides research activity for the exploration and production functions and this service is available on a world-wide basis. Each affiliate purchases research from this company and similarly in the area of research the manufacturing processes and product quality, that was purchased from another wholly-owned subsidiary research company.

Q That's the E and P and Refining Department -- do the E and P and Refining Department of Humble carry on research and development activity?

A Not in any large measure, but you must understand that they must do enough to be familiar with what is going on, what is required in the way of new operations so that they can coordinate their needs with the research organization and also, of course, what results from research that are obtained is needed to be transmitted on down to operating personnel within the company.

Q The research and development activities that you have described conducted by Humble is related to new product development and other development, is that true?

A No, I wouldn't say that the work that is carried on by Humble employees would be involved directly in the development of new products. That has to be done by the research organization.

Q Is it related to the improvement of products?

A No, I think I meant to explain that it is in the area of being knowledgeable about what research is needed and the stages of its development and the results that are coming out of it to be able to have some evaluation for it.

Q Who exercises either the approval or disapproval regarding the top executives of the Production, Refining and Marketing Departments with respect to appointments, promotions, salary increases, bonuses, and the establishment of retirement policies?

A Well, there are a lot of parts to that question.

Q Yes, there are.

A And that cannot be answered yes or no.

Q Can you break it up?

A Break it up? Let's start with the promotions, the

promotions and assignments, and here again the manager or the vice-president, well, you referred to the exploration and production --

Q Yes.

A The Vice-President of Exploration and Production would have authority to make assignments and promotions of employees up to a certain executive level. Above that executive level it would be approved by a Board committee.

Q That is the Board of Directors?

A A committee of the Board of Directors, yes.

Q And with respect to salary increases --

A Salary increases, again for the level from the wage earners up through a certain executive level, would be approved by the Vice-President, and recommendations for increases, salary increases for these higher executives would be reviewed by the Board committee and of course this was to maintain a certain coordination and compatibility among the higher executives of the company.

Q And how about the bonuses and retirement policies?

A The overall retirement policy was developed by the employee relations manager with consultation with the operating functions, and presented and reviewed

and approved or disapproved by the Board of Directors.

Q Do you have Exhibit 20 nearby?

A What was that?

Q Do you have Exhibit 20 near you, sir? I take it you are referring to employee relations also in the middle of the page?

A Corporate staff departments, yes. Again, that is a service that is performed for all of the departments so that there is a certain uniformity of employee policy among all of the employees.

Q Is there established on a company-wide basis a wage incentive plan?

A No, there is no wage incentive plan on a company-wide basis. The Marketing Department, I believe, has an incentive wage plan for a few of its retail heating oil operations; in other words, where we have a retail operation of heating oil, it is customary in the industry for this particular group of people to work on an incentive plan.

Q Is there established on a company-wide basis a bonus plan?

A No. In that period of time with Humble Oil and Refining Company, there was not a bonus plan. I do not believe there was a bonus plan at that time.

Q How about a profit sharing plan?
A No, there was no profit sharing plan.
Q Paid vacations?
A Yes, paid vacations.
Q Retirement plan?
A Yes.
Q Employees' welfare program?
A Do you mean by that such as a sickness and benefit policy --
Q Health and accident program, yes, sir.
A Health and accident, yes.

Q With respect to labor relations is that function carried on at all in -- I am looking again at Exhibit 20.

A All right.

Q -- in the Employee Relations Department?

A No. I testified this morning that each operating function had its separate contracts with its separate labor unions and the management of each operating function conducted its separate bargaining activities with the unions in their particular department.

Q Is the corporate staff involved in any labor negotiation matters at all?

A Yes. There is a small, one or two people in the Employee Relations Department, that provides consultation. And I believe in the Law Department we have a lawyer that's expert in labor law and he is also free to -- he is not free because the operating function gets charged with the allocated part of his expenses. But nevertheless he is available to give them service in this area.

Q Are allstate income and franchise tax returns prepared in Houston during this period?

A We will have another witness who can answer that question for you specifically. I believe they are.

Q I believe you testified that each of the three major departments prepares its own budget and that final approval for that rests with the corporate staff or lower?

A The budget each year was approved by the Board of Directors.

Q Are forecasts and statistics on operations prepared by headquarters?

A I think we might stop to make a distinction by headquarters.

Q I am referring to Houston, yes, sir.

A Well, we need to make a distinction at Houston because, keep in mind, please, that the corporate activities are all handled under this corporate management group. But in this operations management group that you see at the bottom of ~~Page~~ Exhibit 20 that I described, although they are in Houston, they are a part of that particular operating function.

So, to get back to your question, if I might take marketing as an example, at each level beginning with the region level the accounting manager at the region level prepares and provides the necessary reports for the use of the management at the region level. A similar function is prepared

in Houston by the Marketing comptroller for the use of the Marketing Vice-President and his staff. And then in more condensed and abbreviated and summarized form, the comptroller, the corporate comptroller, provides reports for the Board of Directors.

Q Mr. Luper, crude oil has a value, does it not, only because it may be converted into other products?

A Well, it does have a value because it can be, among other things, converted into other products.

Q Now the first major steps for converting crude oil is the refining stage, is it not?

A Again, this is a complex matter and I couldn't give you the answer that might be technically correct. But I would say that I presume that the refinery is the first major step.

Q And the last major step would be the network of retail outlets as a means of disposing of the product, would it not?

MR. RAGATZ: I am going to insert myself here just to ask for a clarification. It seemed to me that the question asked related to the conversion of raw material into product; and all of a sudden he is talking about distribution of

finished product and he has got me confused. I am sure he has got the witness confused. And I don't object to the line of questioning, but I think he ought to ask a specific question that follows.

MR. SHAPIRO: We have an intermediate stage of refining which changed the raw or crude product into another product. That was my understanding of your answer.

THE WITNESS: Well, my answer merely meant to say that the crude is refined, that is the manufacturing operation, and it does end in the production of petroleum products. I wouldn't really call that an intermediate stage. That's the end result of the product.

BY MR. SHAPIRO:

Q The gasoline that results from the refining process is then disposed of by means of the network of the retail outlets, is it not?

A Not entirely. The products manufactured at the refinery are available for sale by the marketing function and a portion of those products are

distributed and eventually sold through service station outlets. But there is also a very large portion of the products that are sold through other distribution channels to industrial and other types of consumer accounts.

Q But isn't the major portion of, say, over 80 per cent in your estimation sold through retail outlets?

A No. I would not say that. I do not have the data at hand to prove or disprove it, but I consider the volume of distillates, the volume of heavy fuel and the volume of gasoline that goes to industrial accounts, consumer accounts, I feel quite certain it wouldn't be anything like 80 per cent.

Q Mr. Luper, if a faulty battery is purchased in Wisconsin at an Enco station and it breaks -- I should say it was purchased in Wisconsin and it breaks down in California, that battery would be replaced in that state under warranty, would it not?

A I have never had a battery break down in Wisconsin that I had to replace in California, so I don't really know that I can answer directly. I have had some difficulty. But I would say that I believe what you say is true.

Q Was it in the 1960's that Humble moved from some quarters

in Houston to the 40-story building that you referred to?

A Yes. I believe Humble has always had a headquarters building in Houston and we were in a building which we owned. And when the new building was built, why, it was moved to the new building.

Q Has Humble counted on the U. S., United States population explosion, to provide better markets for its resources and crude petroleum and natural gas?

A Well, to the extent, of course, that population increases and has a demand for petroleum products, that is a factor that we have to take into account in our forward planning.

Q Do you know the extent of direction and control of the refining function at Houston?

A Well, let me say that the Vice-President in charge of Refining in Houston is responsible, of course, for the overall coordination of the manufacturing activities at each refinery. An operating program has developed for each refinery and the managers of those refineries have responsibility for conducting their operations in the way that gets the most efficient and effective implementation of that operating program.

Q Mr. Luper, as a part of the executive training program isn't there considerable interchange of officers and major employees between departments?

MR. RAGATZ: I think I will have to object to that on the basis of foundation. There has been no testimony that there was any executive training program.

BY MR. SHAPIRO:

Q Is there such a training program or was there during the period in issue?

A Well, there was no formal program if that is what you are referring to.

Q But is there interchange of personnel to carry out the idea of executive training?

A Yes.

Q Between departments?

A Yes. Not on a program basis but on an individual basis.

MR.MORRIS: Would you repeat the answer.

THE WITNESS: I replied that, yes, there were transfers of employees between departments, but not on a formal program or overall program, but just case by case.

Q It is a company policy to transfer employees between departments on a formal basis?

A As a matter of procedure we do that, yes.

Q Now, with respect to transportation and traffic, what transportation policies are set at the home office in Houston?

A Well, again this is a broad question because we have different methods of transportation.

Q I will be specific. For example, if there is an initiation of a new or different method of distribution such as a barge, ship or rail distribution system, is that policy established at Houston?

A I wouldn't refer to it as a policy. It is a practice or an arrangement. It would be developed by the Marketing Department with consultation with the Supply Department; and when a plan hadbeen devised, if that required additional transportation facilities, then the appropriate department would be brought in

facilities are owned and operated by the Exxon Pipeline Company, which was at that time known as the Humble Pipeline Company.

Q How do you define a vertical/ly integrated petroleum company?

MR. RAGATZ: I am going to object to this inquiry on the basis that it sounds like a question that you would ask an expert economist, not a businessman, and I think Mr. Shapiro will have his chance to ask our expert witness that kind of question, and I don't think we should impose that kind of question on this witness.

MR. SHAPIRO: The witness seems highly qualified to answer that.

MR. RAGATZ: I appreciate the compliment to his qualifications, but I don't think we can classify him as an economist.

MR. MORRIS: Do you understand the question?

THE WITNESS: I understand the question.

MR. MORRIS: Can you answer the question?

THE WITNESS: Not if the question involves a legal interpretation or economic interpretation.

MR. MORRIS: Does it involve a legal conclusion or an economic conclusion?

MR. SHAPIRO: No, sir.

MR. MORRIS: Would you repeat the question and specifically state how you wish the question answered?

BY MR. SHAPIRO:

Q Mr. Luper, how would you define the term vertically integrated petroleum company?

A Well --

MR. RAGATZ: Let me interpose my objection so I can ask for a ruling on it as to whether that doesn't -- first of all, it's an opinion that only an expert economist is probably qualified to give. It is a very technical term involving a very technical subject, and I don't think it would be any more fair for counsel to ask him that question than

for me to ask his auditor to try to define that term so I would ask for a ruling that the question be deferred and asked of our expert economist when he takes the stand.

MR. MORRIS: Again, I am noting your objection, Mr. Ragatz, and noting possibly the limited experience in defining the term, do you understand the term and to the best of your ability can you answer that question?

THE WITNESS: Well, if I can answer it in the way I understand it from just a businessman's point of view, but not from an economic or legal context.

MR. MORRIS: Is that sufficient?

MR. SHAPIRO: Yes, sir.

MR. MORRIS: You may answer the question if you understand it.

THE WITNESS: As I understand the question and without providing any legal significance or economic significance, I believe the term is normally applied to a petroleum company that is involved

in all the major operating functions, principal operating segments of the business.

BY MR. SHAPIRO:

Q These segments would be the E and P, Refining and Marketing, to name the three major ones, is that correct?

A Yes.

Q Mr. Luper, as an officer of the company and in view of your responsibility to stockholders, you are concerned very directly with the overall profits of the entire company, are you not?

A Yes, I am.

MR. MORRIS: At this time we will take a ten-minute break.

(Recess, 3:30 p.m.)

Q Mr. Luper, in your direct testimony you stated several advantages of being included under one corporate entity, and including stability of operation, spreading of risk, attraction of high quality of staff personnel, and isn't another advantage -- an this would apply to a vertically integrated company -- the transfer pricing options available that give an opportunity to move profits from one activity into another.

MR. RAGATZ: I am going to object to that. That question, I can't see, has any bearing whatsoever on a tax controversy. That sounds like an anti-trust question to me, and that is well beyond the scope and jurisdiction of this proceeding, and if the Commission were deemed to require the answering of that line of questioning, I would want to ask for a recess and consider whether or not I would instruct the witness to answer that question or whether I consider it an interlocutory appeal. This is not an anti-trust proceeding; this is a tax proceeding. That kind of inquiry has no basis in this proceeding.

MR. SHAPIRO: I fail to see the reason why counsel is so upset with an anti-trust notion unless it is because of the presence of an expert witness for the respondent, but this question relates to functional profits and the entire theme of the petitioner's case is that they take their profits on a functional basis, so that this question is very relevant to the overall operation of the company.

MR. RAGATZ: If he wants to ask the witness, "Do they shift profits" I don't have any objection to that question, but if the overtone of the whole thing is that of an anti-trust inquiry, I vigorously object to it. The question itself was not directed to Humble. It was stated in terms of "Does a vertically integrated company do this." If Mr. Shapiro wants to ask the question, "Does Humble do this," then this witness can give him an answer. If he is asking for industry-wide economic views, I don't think this witness can give him an answer.

THE CHAIRMAN: You object to the broadness of the question?

MR. RAGATZ: I object to that particular question, and I will withdraw it if Mr. Shapiro wants to rephrase the question directing it to Humble, I would then withdraw the objection as to that question, but certainly not the objection to an antitrust line of inquiry.

BY MR. SHAPIRO:

Q Does Humble have options available to it that gives it the opportunity to move profits from one activity to another?

MR. RAGATZ: I have to object to that. That is argumentative. If he wants to ask "Does Humble shift profits back and forth," that is a question the witness can answer. If he wants to argue that profits are shifted, he can do that in the brief.

MR. SHAPIRO: We are referring to options.

THE CHAIRMAN: Are you rephrasing the original question that an objection was raised to?

MR. SHAPIRO: Yes.

THE CHAIRMAN: You are withdrawing the original question?

MR. SHAPIRO: Yes.

THE CHAIRMAN: And now you are rephrasing the question as to apply to Humble?

MR. SHAPIRO: Yes, sir.

THE CHAIRMAN: And you are objecting to it?

MR. RAGATZ: My objection is, if he wants to ask the question, "Does Humble do this," I will withdraw the objection. If you want to ask an economics question which has an anti-trust ramification and not tax ramifications, then I will pursue my objection.

THE CHAIRMAN: Will you please state the question or have the question reread?

(Question read : Does Humble have options available to it that gives it the opportunity to move profit from one activity to another?)

THE CHAIRMAN: Do you understand the

question?

THE WITNESS: I heard the question, yes, sir.

THE CHAIRMAN: Are you able to answer it?

MR. RAGATZ: Mr. Chairman, are you overruling my objection? The form of the question still is objected to as far as I am concerned. He is asking for an opinion of this witness as opposed to asking for an objective fact. This witness is not here to testify as to opinion. That is for an expert witness economist, and if you want to ask the question, "What is the fact," then I won't object to it. If he wants to ask for an opinion, I don't think this witness can answer that .

MR. SHAPIRO: The witness is an executive of the company, and asking whether options are available to the company is not an unfair question.

THE CHAIRMAN: Let me counsel with my attorney.

(Recess)

THE CHAIRMAN: We will sustain your objection to the question, Mr. Ragatz.

BY MR. SHAPIRO:

Q Mr. Luper, how is the supply of packaged oils and greases and similar items obtained? I will add this question: Humble manufactures packaged oil and greases, does it not?

A Yes.

Q Now, do you have Exhibit 21, the map?

A Yes, I do.

Q Do you know at ~~of~~ what plants or refineries the packaged oils and greases are manufactured?

A For general distribution?

Q Yes, sir.

A I know some of them. There are packaged materials of the Baytown refinery, at Bayway, and I believe at Baton Rouge.

Q Now, the source of raw materials for the production of these products would be Humble's own produced crude oil, at least in part, would it not?

A It could be in part.

Q Is it true that an integrated company, such as Humble, that is deficient on crude operates at a disadvantage as compared with a company that is not

deficient on crude?

MR. RAGATZ: Objection. What is the relevance of that inquiry?

MR. SHAPIRO: The relevance is that the supply of crude is an important factor in the source of raw materials.

MR. RAGATZ: Well, that is your opinion and that you can argue, but I don't understand what you are asking this witness unless you are asking his opinion.

MR. SHAPIRO: This gentleman is an expert in his field and that field is oil and gas.

MR. RAGATZ: He is not an economist, and you are talking -- that is an economics question you are asking.

MR. SHAPIRO: He testified as to the stability of the operations as being one benefit, being in one corporate entity.

MR. RAGATZ: He is talking about Humble.

MR. SHAPIRO: Yes.

MR. RAGATZ: And your question doesn't relate to Humble; your question was any company. I am not -- he can testify as to facts as to Humble, but I don't think

he can testify as to the opinions as to how things work in the industry. If he knows facts of the industry, he can testify to that.

MR. SHAPIRO: Well, I will rephrase that question.

BY MR. SHAPIRO:

Q If Humble were deficient ~~on~~ in crude, would you consider that as a disadvantage.

MR. RAGATZ: I guess I would stipulate that if Humble or anybody else was deficient ~~on~~ in crude, in the industry that would be a disadvantage. I guess I don't understand the question.

THE CHAIRMAN: Can you answer the question.

A Well, presuming that the refinery did not acquire the crude in another manner, yes, it would be a disadvantage.

Q Would that disadvantage be reflected in all departments, all major departments of the company?

A I don't see how it could.

Q Mr. Luper, the federal depletion allowance is based on net income from production, is it not?

A Yes.

Q And such net income is ~~completed~~ computed before any so-called downstream activities are involved, such as refining or marketing, isn't that correct?

A The depletion allowance is based upon well head value of the crude.

Q So that the E and P net income must be determined for purposes of the federal depletion allowance, isn't that true?

A The revenue from production of oil and gas must be determined, and that is in the operation or within the operation of the E and P function.

Q And the larger profit that results, the greater is the amount of depletion allowance within certain limitations?

A I never encountered any profit from the payment of taxes, Mr. Counsel.

Q I am referring to reduction of federal income taxes.

A If you mean the tax benefit?

Q Yes, sir.

A Would you please restate your question?

Q The larger that income is, the greater the tax benefit, the greater the tax benefit would result in the form of a depletion allowance?

A Yes, the larger the revenue from crude oil and gas, the larger the depletion allowance and therefore the larger the tax benefit.

Q Doesn't the home office at Houston have experts in economics and marketing who provide services for assessing the desirability of putting new service stations in a given area?

A The staff is available to the vice president of marketing, it is competent to give him advice on location of new service stations.

Q Does the home office put out circulars covering changes in laws such as workman's compensation, unemployment compensation, wages and hours, social security and that sort of thing?

A Well, as a service for all or each of the operating functions, one of the corporate staff departments, probably Employee Relations or perhaps Tax, would advise the vice presidents and general managers of the operating departments and then each of them would have its own administrative staff prepare the necessary information for the benefit of its field organization.

Q Do you have any knowledge, sir, as to how a product came into Wisconsin in 1968 or during the years in

issue?

A 1968?

Q Yes, sir.

A I have only a general knowledge.

Q Was gasoline carried into Wisconsin for Humble by the West Shore Pipeline Company.

A It is my understanding it was.

Q And was some of that product carried from Hammond, Indiana?

A It may have been. I really don't know.

Q And was some of it carried from Romeoville, Illinios?

A It may have been. I still do not know.

Q And did Humble obtain such gasoline pursuant to an exchange agreement?

A It is my understanding that it did.

Q And with what company or companies?

A Well, it was at that time I believe -- it was the Pure Oil Company was one of the companies.

Q Are you aware of any others, sir?

A I am not aware of any others at that time. I am not certain that is the only one.

Q Do you know where those exchange agreements were negotiated?

A No, I do not.

Q Do you have any understanding as to where they might have been negotiated?

A I would presume they were negotiated in the Houston office of the Supply Department.

Q Do you have knowledge as to the location of the terminal at Jones Island in Milwaukee, sir?
A I haven't heard of Jones Island.
Q Do you know whether Humble had a terminalling agreement with Phillips Petroleum Company at Jones Island?
A I understand that there was one.
Q And do you know whether that agreement was in writing?
A No, I do not.
Q Do you know what official of the company would have negotiated such a terminalling agreement?
A No, I do not.
Q Do you know whether the product was carried ~~cased~~ by the West Shore Pipeline Company into Wisconsin and destined for Green Bay, Wisconsin?
A I do not know. I assume that it was. It could have been but I don't know that for a fact.
Q Did Humble have a terminalling agreement with Cities Service Oil Company at Green Bay?
A It's my understanding that they did.
Q And do you know what official of the company would have negotiated that agreement?
A No, I do not.
Q Was there a transportation agreement in existence between your company and West Shore Pipeline Company?

A There will be another witness on tomorrow who can answer that factually. I would be surmising.

Q During the years in issue do you know approximately what per cent of sales in Wisconsin werederived from sales of gasoline?

A No, I don't have that information at hand.

Q Or, stated another way, what per cent was derived from sales of TBA greases and lubes?

A I don't have that information.

Q Can you explain what personnel managed a terminal and how many persons are involved?

A No, I am not familiar with that operation.

Q There were approximately 350 retail outlets in Wisconsin during this period, isn't that correct?

A I don't know the number but that may be in the range.

Q And in addition to that there were two or more Car Care Centers in Milwaukee and other areas?

A I do not know that for a fact but I would not be surprised.

Q Who would have the final authority to determine whether a Car Care Center were to be opened?

A If you are referring to Wisconsin the regional manager of the Central Region.

Q Now it is the supply part of the corporate staff that

arranges for the crude oil processed at Humble refineries, is that correct, sir?

A If you would just explain your question I would understand it.

Q Did you ask me to explain it?

A Yes, elaborate on it.

Q Oh. The corporate staff that you have indicated as supply, does that function arrange for crude oil delivered to Humble refineries?

A It would be the Department who would plan and develop a program for that movement.

Q When you look at Refining and E and P together, is it true that Humble can make a larger profit per barrel from crude oil that Humble produces and refines than it would from crude oil that is purchased and refined?

A Well, as far as the profit on the crude oil produced by Humble, ~~product~~ produced by E and P, it would be profit-related to the production of that oil. Any profit made by the Refining Department, whether its from oil produced by Humble or oil purchased from another producer, is derived from the investment in and the operation of the refinery.

Q One of the major reasons for Humble owning its own

refineries is to process its own produced crude oil, is that true?

A I testified this morning that the attractiveness of refinery investments are directly related to a stable and assured supply of crude oil and raw materials.

Q If it costs, for example, two dollars to take a barrel of crude out of the ground and the posted field price is four dollars, then E and P has a two-dollar profit on that, is that correct?

A Well, I don't know what you -- if you are just defining the four dollars as the revenue and the two dollars as the entire cost and operating cost to go with it, why obviously the difference is two dollars.

Q Well, I am asking whether, if it costs two dollars to take a barrel of crude out of the ground and the posted field price for that barrel of crude is four dollars, then there is a two-dollar profit to E and P, is that right?

A I can only tell you that the two dollars to E and P only results if the two dollars is the complete cost including all taxes and everything else.

Q Yes, sir. We are assuming that. And then that barrel of crude would be charged to the Refining Department at four dollars, would it not?

A Whatever the posted price was plus the appropriate pipeline tariff for transportation to the refinery.

Q And if the refining cost is a dollar added to the four and the wholesale price to marketing is 5.50, there will be a 50-cent refining profit, is that true?

A I haven't followed your arithmetic. It is kind of complicated.

Q Well, I am trying to keep the numbers real simple.

A Well, I have a pencil. Refining paid four dollars for the crude?

Q Yes, sir. We assume that four dollars was the posted field price and that it would be charged to refining at four dollars.

A Including the transportation?

Q Yes, sir.

A All right.

Q And then the cost of refining is a dollar added to that, and the wholesale price, when it's transferred to Marketing, is 5.50. Isn't there a 50-cent refining profit?

A Yes.

Q Now let's take it one step further and assume that in Marketing the cost is four dollars added to the

five. Well, it's charged to marketing at 5.50, is it not?

A Yes, plus transportation.

Q Yes, sir. And we add four dollars as marketing costs which brings it to 9.50 for the quantity of fuel that is refined from that barrel of crude. Let's suppose that Refining sells that for nine dollars. There is a 50-cent loss to Marketing -- I should say Marketing sells it for nine dollars, then there is a 50-cent loss to Marketing, is that right?

A According to your figures.

Q Yes, sir. Now previously in Refining we have had a 50-cent profit and in E and P a two-dollar profit. That's 2.50. And then you net a 50-cent loss, so the net profit to the company would be two dollars under those assumed facts, is that right?

A Before taxes?

Q Yes, sir.

A And the other overhead costs perhaps, that's right.

Q Yes, sir.

Q With respect to exploration, Mr. Luper, the division office for the area that Wisconsin happens to fall in is Oklahoma City, is that correct?

A Let me see. In this period of time it might have been Oklahoma City or it might have been Tulsa. I am not entirely positive.

Q Do you have knowledge as to the structure of that Oklahoma City Division Office, as to the number of employees and functions?

A No, I have knowledge of the functions, but not of the number of employees.

Q Will you state that, sir?

A Of the Exploration Office, of the Division Office?

Q Yes, sir.

A It was the Division Field Office of the Exploration Department. It was a self-sustained contained unit in the geographic area assigned to it, and it was responsible for implementing the exploratory programs for that particular geographic area.

Q And is that headed by a manager?

A A manager, yes.

Q And to whom is the manager responsible to?

A Well, he is responsible to the Vice-President of Exploration reporting through an operations manager

that is an assistant to the vice-president.

Q Within the scope of the manager's authority would he have authority to enter into new leases?

A Yes, he would.

Q And explore new areas?

A Yes.

Q And expand on exploration within certain limits?

A What do you mean by "expand on exploration"?

Q Expand with respect to investments.

A Here again he is operating within a program and if he should decide or desire to go into a new geographical area that was outside this program, then, of course, he would have to discuss that with the Exploration Vice-President.

Q And supposing that a significantly more aggressive and active exploration activity was contemplated, who would have the final approval of that?

A If that involved a substantial expenditure of money it would be incorporated in the budget and that budget, as I said before, would essentially be approved by the Board of Directors.

Q In the early 1960's Humble had more crude than its refined product market could absorb, isn't that true?

A I haven't looked at that data and I can't tell you

for sure.

Q Isn't it also true that the company decided to expend large sums of money in order to look for more crude at that time?

A I believe it has been the company's policy as long as I can remember to always spend the money for prospecting for new oil and gas reserves where we thought it was a profitable activity.

Q Is it true that the officials of the company believed that the oil consumption was going to grow a lot faster than anyone expected in the future and the instructions were to locate, explore and locate and find all the oil you can?

A I can't speculate what the officials of the company thought would be the future consumption trend, but Humble Oil and Refining Company has always been a company interested and willing to invest in the search for new oil and gas reserves.

MR. SHAPIRO: Off the record.

(Discussion off the record)

Q The company official that coordinates refining operations throughout the United States would be the vice-president for Refining?

A Yes.

Q Now, a refinery is operated continuously, isn't that true, except for brief periods of shutdown?

A Yes, that's correct.

Q And that shutdown is for maintenance purposes?

A Usually.

Q And there must be a continuous supply of crude available for the economic operation of the refinery, is that true?

A Adequate supplies to operate the refinery must be available.

Q Is the crude stored in large tanks outside the refinery?

A Well, it is stored in large tanks. Some are outside the refinery.

Q Doesn't the company have an economic incentive to refine as much of its own crude as possible?

A No. As far as profit to be derived from a manufacturer of barrel crude, it would be the same whether we obtained it from the production from our own produced crude or whether we purchase it from the outside for the very simple reason that we have had to make an investment in that refinery to produce that barrel of crude.

Q Now, the annual reports of your company that are in the record show refinery crude oil runs at, for example, 900,000 barrels a day. Now, in order to obtain the total barrels transferred to a refinery for a year, would you multiply the 900,000 by the number of days the refinery operated during that year or by some other number?

A I am not familiar -- I don't have in front of me the data that you are looking at. Are you asking an exact question ~~of~~ or a hypothetical question?

Q Well, I prefer not to take the time to go through the annual reports, but if for the moment we can assume that 900,000 barrels a day is a refinery's crude oil run total --

A Total crude oil run?

Q Yes, crude oil run.

A Yes.

Q Now, that is on a daily basis?

A Yes.

Q In order to obtain the total barrels transferred for a year, what would you multiply it by, 365?

A To get the total barrels run in a year, by 365.

Q I see. Now, again let us assume that the total production of crude in a given year, say, 1965, was

200 million barrels and 65 million barrels were sold at the lease and the remaining 135 million barrels were transferred to supply and that an additional 300 million barrels were purchased, now, I would like to ask you with respect to the 65 million barrels sold at the Lease, to what extent would these sales have been made pursuant to the exchange agreement?

A I would have no way of knowing what percentage. There will be a witness on tomorrow who may have some information on that matter.

THE CHAIRMAN: Off the record.

(Recess)

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THE CHAIRMAN: On the record.

BY MR. SHAPIRO:

Q Mr. Luper, there are some 23,000 wells in the producing states, isn't that correct?

A I don't have the figure at my fingertips, but that could be correct.

Q It sounds reasonable?

A Yes.

Q I have taken the 1967 annual report from Mr. Sheridan's work papers, and on Page -- you are familiar with the company's annual report, sir, are you not?

A If that is in '67, it has been seven years since I have seen it.

Q I meant in a general way. I refer you to Page 7 and the statement that reads --

A This is the annual report of Standard Oil Company of New Jersey, not the Oil and Refining Company.

Q That is correct, this is referring to the United States operations here, sir. It says, "With reference to the United States operations of Humble Oil and Refining Company, despite production increases Humble continues to have the largest domestic oil and gas reserves of any company in the nation, and thus remains in an excellent position to participate in supplying increasing demand."

A Yes.

Q Doesn't that indicate a contribution of the E and P Department to the Marketing Department --

MR. RAGATZ: Objection. I think the document speaks for itself, and I think he is again asking an opinion and that opinion has a legal conclusion written all over it.

THE CHAIRMAN: Do you want to answer Mr. Ragatz' objection?

MR. SHAPIRO: Well, I am asking for the judgment of the witness. He is an expert businessman.

THE CHAIRMAN: I think the record speaks for itself and I don't believe that it is necessary to answer that question. The objection is sustained.

BY MR. SHAPIRO:

Q Isn't it true, Mr. Luper, that the Refining and Marketing Departments represent a means to get crude oil produced?

A No, I wouldn't see how that would follow.

Q I didn't hear your answer.

A I don't see how that could follow.

Q For the period in issue, 1965 through 1968, what was the -- in your best estimation, what was the percentage

of return on investment for E and P, Refining and Marketing?

MR. RAGATZ? Combined?

MR. SHAPIRO: No. For each one.

MR. RAGATZ: If you know.

Q If you know.

A That is a year -- I have made no preparation to give you a figure on that.

Q Would you hazard a guess?

A I prefer not to.

Q The packaged lubricating oils and greases and industrial oils and greases that were manufactured by Humble were sold in Wisconsin, isn't that true?

A I believe that is true.

Q Off the record.

(Discussion off the Record)

Q No further questions at this time.

THE CHAIRMAN: Mr. Ragatz? Redirect?

MR. RAGATZ: Just a couple of quick questions.

EXAMINATION

BY MR. RAGATZ:

Q Mr. Luper, cross-examination raised the question of transportation facilities. Does much of the crude and gasoline that is transported in connection with the

Humble operation get transported by facilities not owned by Humble, or did it during the years in issue?

A Would you restate that, please?

Q Maybe I can make it clearer. The transportation of crude --

A Excuse me --

Q -- and gasoline --

A Excuse me. Would you separate it between crude and gasoline?

Q Let's take crude -- the transportation of crude is taken mostly through pipelines?

A Yes.

Q And were these pipelines owned by Humble Oil and Refining Company?

A No.

Q And how about gasoline? How was that transferred and in whose facilities?

A Gasoline was transferred in a number of ways; gasoline was transferred by pipeline and transferred by tanker and by barge. As I have testified, the products that were transported in Humble-owned equipment was the marine equipment, but those that were transferred by pipeline was by -- by some pipeline, it could have been Exxon ~~at~~ or Humble.

Q Or other pipelines?

A Or other pipelines.

Q Mr. Shapiro also asked you about a concern about profits for the shareholders. Would you comment on the concentration of profit concerns by functional departments as being the primary source of profit concern?

A Well, of course the profits of each of the individual functional segments go into determination of the overall consolidated profits and as such, why obviously the functional profits are important to us, as well as the overall corporate profits.

Q Profits are determined by function -- in accordance with your functional profitability independence policy?

A Yes.

Q You were asked about the determination of the depletion deduction and its impact. Now, do you or do you not use the same or similarly-determined well head values for purposes of calculating the royalty interest that you have to pay the third-party royalty owners?

A Yes.

Q And do you use the same determined values for calculating the amount of the working interests that you

have to pay the owners of those working interests?
A For the value of their share of production?
Q Correct.
A Yes.
Q And do you use the same determined values to arrive at the amount of the severance taxes that you must pay to the various states in which the production occurs?
A Yes.
Q Now, are these profit benefits or profit detriments in each case?
A Well, in each case to the extent that they are cost, they are economic detriments.
Q No further questions.

MR. SHAPIRO: May I ask one question?

EXAMINATION

BY MR. SHAPIRO:
Q Mr. Luper, in your experience as a certified public accountant and your broad experience in business, isn't it common for corporations that ~~to~~ transfer product from one division to another for further processing to have profit centers?

MR. RAGATZ: Would you read that back?

(Question read)

MR. RAGATZ: That is what I thought he said.

This witness is not qualified as an expert in the business of all kinds of companies. His background clearly indicated that he has been with the Humble Oil and Refining Company and related companies for -- I forget how many years -- and I don't think that he is qualified to give an opinion as to what businesses do generally, despite the fact that he is highly well-qualified by education and experience in the business of Humble Oil and Refining Company, so I would object to that question as asking for an opinion evidence that this witness is not qualified and under these circumstances --

MR. SHAPIRO: I submit it is a fair question on the basis of business judgment.

MR. RAGATZ: I guess you would agree, you are asking for an opinion, though?

MR. SHAPIRO: No, it isn't. It is a matter of fact as to whether profit centers are established in other corporations that I referred to. That is a factual question.

BY MR. SHAPIRO:

Q From your own knowledge, Mr. Luper, did --

MR. RAGATZ: Let me inquire, did you

refer to corporations generally or to the oil industry?

MR. SHAPIRO: I am not restricting it to the oil industry.

MR. RAGATZ: Then my objection stands. If you want to ask about the oil industry, maybe he does know, but I don't think he can answer as to the corporation generally.

MR. SHAPIRO: He is a member of various professional societies and he has broad experience in business.

THE CHAIRMAN: I will sustain the objection. Anything further?

MR. SHAPIRO: No, sir.

THE CHAIRMAN: There being nothing further, it is 4:45 and we will adjourn the hearing until 10:00 o'clock on Monday morning in the same court room.

MR. MORRIS: Before we adjourn, will we need this witness for any further testimony in this hearing?

MR. RAGATZ: No.

MR. SHAPIRO: No.

MR. MORRIS: Mr. Chairman, then I would assume you can excuse this witness for any

further testimony.

THE CHAIRMAN: I assumed he was excused. We will excuse you formally, sir.

(Witness excused)

(This matter was adjourned to 10:00 A.M., Monday, October 7, 1974.)

STATE OF WISCONSIN

WISCONSIN TAX
APPEALS COMMISSION

* *

EXXON CORPORATION, (f/k/a Humble Oil and Refining Company),

Petitioner,

vs.

Docket No. I-3806

WISCONSIN DEPARTMENT OF REVENUE,

Respondent.

* *

CERTIFICATION

KAREN A. CHERRY
MINDLA COMINS
LORETTA PETERS,

hereby certify that as the duly appointed reporters, we took in shorthand the testimony and proceedings had in the foregoing matter on the 4th day of October, 1974, and that the attached is a true and correct transcription of said shorthand notes and of the whole thereof.

Dated this 4th day of October, 1974.

Karen A. Cherry

Karen A. Cherry

Mindla Comins

Mindla Comins

Loretta Peters

Loretta Peters

STATE OF WISCONSIN | WISCONSIN TAX APPEALS COMMISSION

* *

EXXON CORPORATION, (f/k/a Humble Oil and Refining Company),

Petitioner,

vs. Docket No. I-3806

WISCONSIN DEPARTMENT OF REVENUE,

Respondent.

* *

TRANSCRIPT OF PROCEEDINGS in the above-entitled matter held before the Wisconsin Tax Appeals Commission, in Room 229, City-County Building, Madison, Wisconsin, on the 7th day of October, 1974, commencing at 10:00 in the forenoon.

PRESIDING: R. J. SMRZ, Chairman
THOMAS R. TIMKEN, Member
JOHN P. MORRIS, Member

ALSO PRESENT: JAY C. GITCHELL, Hearing Examiner.

A P P E A R A N C E S

BOARDMAN, SUHR, CURRY & FIELD, Attorneys at Law, 131 West Wilson Street, Madison, Wisconsin, by THOMAS G. RAGATZ,

and

McBRIDE, BAKER, WIENKE & SCHLOSSER, Attorneys at Law, 110 North Wacker Drive, Chicago, Illinois, by LLOYD M. McBRIDE and PAUL D. FRENZ,

and

ROBERT E. TANNEHILL, Tax Attorney, Exxon Company, Houston, Texas, appearing on behalf of Petitioner.

IRVING F. SHAPIRO and ROBERT M. FINLEY, Tax Counsel, Wisconsin Department of Revenue, 201 East Washington Avenue, Madison, Wisconsin, appearing on behalf of Respondent.

MR. MORRIS: We will continue the hearing regarding the above matter.

Mr. Ragatz, you have a request to make before you call your next witness?

MR. RAGATZ: For purposes of the record, I am not sure that on late Friday afternoon the record would show that Mr. Luper was excused as a witness with consent of counsel for the respondent.

Also on Friday there was discussion of the production of certain documents if they were found to exist, and I want the record to show that this morning I provided Mr. Shapiro with a copy of an exchange agreement with Pure Oil Company that we understand affected products coming into Wisconsin. I also advised him that our people have advised me that there was no exchange agreement with Shell Oil Company and that the Cities Service agreement did not affect the years here in issue. The Shell agreement and the Cities Service agreement, having been requested by counsel for respondent, we will have a witness here today who can be questioned by

counsel for respondent on that subject.

MR. SHAPIRO: And after we have had an opportunity to review the exhibit, we will take into consideration whether we want to introduce it into the record.

MR. MORRIS: It is not part of the record at this time.

MR. SHAPIRO: Not at this time.

MR. RAGATZ: I will deem, unless advised otherwise, that we have complied with the request for production of copies of applicable exchange agreements.

MR. MORRIS: On the question you raised of Mr. Luper, whether he was excused or not, I think it was ruled on Friday that he was excused and there is no reason for any further testimony from Mr.Luper. That ruling will hold unless there is a reason to have Mr. Luper called back.

MR. SHAPIRO: Did I understand you to say we raised a question?

MR. MORRIS: No. Mr. Ragatz raised a question on whether he was excused or not.

MR. RAGATZ: It was our impression that he was, but I wasn't sure that the reporter was still taking transcript on that point, so --

MR. MORRIS: So the record will reflect that Mr. Luper completed his testimony and he was excused and there was no objection on his excusal by either party.

Mr. Ragatz, you may proceed.

MR. RAGATZ: The petitioner calls John G. Jeager.

JOHN G. JEAGER,

called as a witness, having been first duly sworn under oath, testified as follows:

EXAMINATION

BY MR. RAGATZ:

Q Please state your full name for the record.

A John Glen Jeager.

Q Where do you live, Mr. Jeager?

A Houston, Texas.

Q How old are you?

A Fifty-eight.

Q Would you summarize your educational background?

A I attended Rice University in Houston, graduated with a Bachelor of Science degree in Mechanical Engineering. I have attended the Advanced Management School at the University of Pittsburgh in 1960, and in 1968 I attended the Brookings Institution School for Managers.

Q What professional societies do you belong to?

A I belong to the Society of Petroleum Engineers, the American Petroleum Institute, the Mid-Continent Oil and Gas Association.

Q What is your present occupation?

A I am a petroleum consultant.

Q How long have you been so engaged?

A Just one month.

Q What did you do prior to that?

A For 38 years I was with Exxon. I had a number of positions starting in the Gas Department and field work later as a gas engineer, and then a superintendent in charge of the gas operations in the area east of the Sabine River. I then went into the Production Department where I had -- I was Assistant Division Manager in charge of producing operations in the on-shore area of Louisiana and Mississippi; and in

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1961 I became manager of the Crude Oil Department of the Humble Oil and Refining Company, moved to Houston, and, well, for five years I was manager of Crude Oil; and then in 1965 I assumed also the responsibilities for supply, commerce arrangements for bulk products and gas liquids as well as crude oil.

Q Did you continue in this position until your retirement?

A That was the position I had when I retired on the 1st of September of this year.

Q That would include the entire period in issue, 1965 to 1968?

A Correct.

Q Now would you describe a little further the duties and responsibilities of that position?

A The principal responsibility was to manage the crude oil supplies of the company in the United States. This broadly covered the disposition of all the company's produced crude and responsibility to say that the company's refineries had adequate supplies of the proper types of crude to meet their requirements, the carrying out of these responsibilities, and the group under my supervision bought and sold

crude oil all over the United States. We sold our own production and we bought oil as needed to fill out the requirements.

Q How many years of experience have you had in the oil and gas industry?

A Thirty-eight years.

Q Now in addition to what you have already described as your position, what were the functions of Humble's Supply Department with respect to crude oil during the years in issue?

A Well, in addition to the movement of crude, that is the buy and sell, the transportation activities, we had some planning responsibilities with regard to expansion of refineries, what future supplies might be, and we had responsibility to appraise the market to determine what proper prices should be for the crude oil, and it was my group that would develop pricing strategies and pricing -- actual pricing changes that would be made, and recommend such changes to the Board of Directors.

Q What was the function of the Supply Department in respect to crude oil in connection with the interests of royalty owners?

A Well, the Supply Department bought crude oil from

royalty owners. The purchases I spoke of a while ago included purchasing crude from royalty owners, purchasing crude from non-operating working interest owners under Humble-operated properties as well as purchasing crude from other producers.

Q Would you explain just briefly the interest of a royalty owner in a particular well or in a particular lease and also the relationship of the joint working interest, just for background for the Commission?

A All right. The royalty owner under a lease is the owner of the mineral interests. There are, generally broadly, two interests in a lease. There is a working interest and a royalty interest. The working interest usually is represented by the oil company or the producer. The royalty interest usually is the land owner, and when a land owner leases his land to a producer, he retains some interest in the minerals that will be recovered from the land, and that is what we call "royalty."

Now he retains that -- in the case of oil, the royalty owners retain the interest in percentage of the oil produced, such that he owns the oil when it is produced, and hence someone has to buy that oil from him, unless he has reason to use it himself,

and of course it is always the case that the royalty owner sells his oil under contract and the purchases I spoke of were the purchases we made from royalty owners of the so-called royalty interest.

Q Would you also explain the operation of a joint working interest?

A The second category, joint working interest, it is very frequent in the oil field that several companies will own a producing property for a number of reasons, but always one company is selected to be responsible for the operation of the property, that is the drilling of the wells and the producing of the wells to see that the equipment is there, the people are there, and all the supplies are delivered and handled right, and then the operator has some responsibility to see that the production is moved to the lease when the production begins.

Now each of the participating producers in this joint property has the obligation to take his production away from the lease. Frequently they produce -- the non-operating producers choose to have the operator make the sale of oil for him. The mechanism to use is the operator buys the oil from the non-operator, and then turns around and

sells it in the market.

Q Now who determines what portion of the Humble-produced crude would be transferred to the Humble Refining Department during the years in issue?

A Well, there is no such determination made, as such. There was a distinct break between the disposition of produced crude and the acquisition of crude for the refineries.

Q What factors were considered in determining whether you would dispose of Humble-produced crude or whether you would transfer it to the Humble refinery?

A There are three principal factors. First would be location of the production; that is is it near a refinery or near a transportation system which could economically move the crude to a refinery.

Secondly, the quality of the crude. Actually the crude, any crude that goes into a pipeline system loses its identity as to the origin. It is identified only as to quality.

Humble produced crude then would be disposed of in the most economical market.

Q Is there any policy of the company that required you to transfer Humble produced crude to the Humble Refinery Department?

A No.

Q Was that Refining Department required to acquire its crude from the Humble E and P Department?

A No.

Q Who determined that transfer price when Humble produced crude was transferred to the Humble Refining Department?

A Humble produced crude was always transferred to the Supply Department on the basis of a posted field price for the field in which the crude was produced.

Now, when the Humble produced crude then

was in the pipeline system, it moved where the most desirable market might be, and in some cases that might be a Humble refinery.

In other cases, it would be a sale to other refineries, but there was never any identification of the crude origin after it entered the pipeline.

Q Did the Humble E and P Department have any say in setting that posted field price at which crude was transferred?

A No.

Q Did the Humble Refining Department have any say in setting that price?

A No, they did not.

Q Would you explain the concept of a posted field price?

A A posted field price is a published price at which a company, or which a company is willing to pay for crude that it may buy in a particular field. The price applies to all purchases of that particular crude, but it is not a commitment to buy. It is only a publication of the price at which crude will be purchased if it is purchased.

Q How is the price determined?

A The determination really begins in the product market. The price of products is backed through the refinery cost of manufacturer including the cost of distribution

of the product and the cost of manufacturing of the product, and then the cost of transporting the crude to the refinery back into the posted field price.

Now, of course, you don't go through that complicated pricing mechanism everytime you study posted prices because the system is already established so really the current method of determining a posted price under the established system is what are the competitors paying. If a company needs crude, they have to pay the competitive price.

Q Who generally determines this price?

A Well, the Supply Department did that. That is part of my responsibility, to determine what Humble had to pay in order to buy the crude it needed.

Being a buyer, we were interested in buying at the lowest price, but we couldn't pay less than the market and get the crude we needed.

Q In any particular field what determined what the posted field price was?

A In any particular field, again the price -- assuming we would be the only poster in a field, the price would be the going price for similar crude in the market having to do with quality, location of the crude.

Q Is there likely to be more than one posting in a particular field?

A Many times there is more than one posting when there is more than one purchasing company.

Q How would the prices of the various companies compare?

A They are usually the same.

Q Would you explain that?

A Yes. As I said a while ago, a company who wants to buy crude, they, of course, want to buy it at the lowest price so they -- in order to keep the price down. On the other hand, if there is competition in the buying, that tends to drive the price up, but there is an upper limit to what the company can pay because of the cost of moving to the refinery, manufacturing the product, and then competition in the product market.

Now, all these factors get worked into what the industry, the competitive prices will be in any particular field.

Q Now, to what kind of an area does a particular posted price apply?

A There are two broad types of posting. One is for a field, and, secondly, for an area such as the South Louisiana Offshore, which represents quite a large

volume of production and generally a company will post one price for all offshore production.

Q Define what you mean by a field.

A A field?

Q A field.

A Technically a field is a producing area, geographical area under which there is oil and in which there are wells producing the well. In some cases, particularly in Texas, a field might be designated as a reservoir and there may be several underlying reservoirs under one piece of surface geography, and technically there could be several fields in one area. That is not too common, but it is a distinction.

Q Now, when are postings made in respect to a new field?

A Usually when production of the field reaches a quantity of 400 to 500 barrels per day.

Q Now, you mentioned earlier that these posted field prices are published. Will you explain what you mean by published?

A Yes. They are printed on a bulletin and the bulletin is distributed very widely, and, secondly, it is posted on the bulletin board at the building of the company who is purchasing the crude. These published bulletins are mailed to the media and any interested

parties. Usually the interested parties are the other producers in the field and refining companies who might buy the oil.

Q So these are available to all potential buyers and sellers?

A Yes, yes. They are public knowledge and frequently are published by the oil media as a service to the industry.

Q Earlier in the testimony in this case an exhibit was introduced and admitted into evidence which consists of a paper written by one of the witnesses, Mr. Kaspar, and another man entitled "Auditing Oil Companies," and that exhibit is number 11-11 in this case.

I would like to read you a statement out of that exhibit and then ask for your comments. This begins on Page 1 of the exhibit.

"Although each of the above activities is very different from the others, it may be stated that, in general, the major oil companies do not separate these activities along corporate lines, but rather by departments, each of which is headed by a vice president. In some cases, however, the exploration and producing activities are incorporated separately from the storage, refining and marketing

operations. Separation at this point is convenient and practical because of the readily determinable market price of crude oil at the well head; that is at the point where crude oil first reaches the surface of the earth. All crude oil produced in an area has a value equal to the posted field price, which is the announced price currently paid by purchasers at the well head in a specified production area. These posted field prices are circulated by all large buyers and are bona fide competitive prices, not subject to manipulation or rigging and are effectively policed by state regulatory agencies. The posted field price controls what a company receives for its own production sold to others as well as what it pays for production bought ~~back~~ from others. This is true even where it buys crude oil and resells it to others rather than using it in its own refineries. Crude oil sold at a point elsewhere than at the producing premises is sold at the posted field price plus transportation."

Do you agree with this statement in Mr. Kaspar's paper?

A Yes, I think it is very well expressed and it is accurate.

Q And to the best of your knowledge based upon your long

experience, this statement accurately reflects the situation in the market?

A Yes, it does.

Q And the use of posted field prices?

A Yes.

Q Would you explain any other uses of posted field prices?

A Well, other than as we have said to use them as a price for all purposes, all sales of oil, transfer price between departments as from the Exploration and Production Department into Supply, if all the oil which the Supply Department acquired was acquired on the basis of a posted field price and that price determined the cost of acquisition of all the oil in the Supply, and that cost of acquisition was the basis used in transferring the crude to our own refineries or in pricing the sale of crude to a third party.

Q Now when Supply acquired the crude was it doing so on behalf of the Refining Department?

A No, no. Only in certain cases where a special crude was needed by the Refining Department. You say we were doing that, but in many of those cases we were buying the crude from outside.

Q Now explain the use of posted field prices in determining the amounts due to royalty owners?

A The posted field price is the price stated for payment to the royalty owners in the contract under which we purchased the oil.

Now rather than name a dollar price, we just said that we would buy the oil based on the posted field price for that field and, of course, those contracts had been in existence for 20 or 30 years. And whatever the posting is, that's the basis that payment has been made to the royalty owners through all those years.

Q The royalty owners generally accept a price determined by the posted field price?

A That's correct. They do that.

Q Is the same true for purchasing oil from working interest?

A Yes. In fact, the same wording is used. Rather than name a dollar number, you would name the oil, that the oil would be purchased on the basis of the posted field price information for the field in question.

Q And do the posted field prices determine the selling price when you are selling crude to third parties?

A Yes, we have sales contracts with the same wording.

Q And is the same true when you are purchasing crude from third parties?

A Correct.

Q Do other companies in the industry use posted field prices?

A Yes. There are just many, many companies posted. I don't have an idea. Probably 50 or 60 companies issue postings for crude they purchase wherever they may be purchasing.

Q What percentage of total industry crude production comes from companies who do not have their own refineries?

A Oh, probably 20 per cent.

Q And do these companies sell their produced crude at posted field prices?

A Yes, yes.

Q And do the companies in the industry that have refineries but no E and P function, purchase their crude at posted field prices?

A Yes, they do.

Q Now based upon your experience does the industry accept posted field prices in the measure of the profit derived from the sale of crude at the well head?

A Yes, they do.

Q Also based on your experience is this measure of the profit derived just as applicable to crude transferred to Humble's Refining Department?

A Yes.

Q During the years in issue did Humble make exceptions to the use of posted field prices on transfers between its E and P function and Refining function?

A Never.

Q Never?

A Never.

Q No exceptions?

A No.

(Exhibit Numbers 23 and 24 marked for identification)

Q I show you what's been marked as Exhibit 23 and ask you to identify what that is.

A This is a tabulation entitled Crude Oil Posted Prices, named in dollars per barrel. It lists the posting for four grades or qualities of crude. The four are identified in the first line across the top as South Louisiana, North Louisiana, West Texas and East Texas.

These are four typical crudes of which there are large volumes or else they are very important to the industry because of their quality.

Q From what information was this exhibit prepared?

A This was prepared from records in our files, the

record being the published bulletins of the various companies. And you will note under South Louisiana we have listed postings of four companies, Exxon, Gulf, Texaco and Superior.

And we have in our files their posted prices through the years and we have listed here the price they pay for the crudes named, or, rather, the fields named.

The fields are listed under the company name for Exxon, Grand Isle, Block 16; Gulf, Delta, Ostrica; Texaco, Caillou Island; and, Superior, Bosco. And these are all South Louisiana field with similar-quality crude.

Q Did you prepare this exhibit?

A It was prepared under my supervision.

Q Now why have you included Superior along with the majors Exxon, Gulf and Texaco in the South Louisiana field?

A Superior is a producing company with no refineries. However, there are locations where Superior has a gathering system primarily for its own crude and they buy other crude in the area, put it in their gathering system and then sell it.

Q Now you heard the testimony of Mr. Luper on Friday.

Is Superior one of the companies that fell into the classification in his Exhibit 22 that showed examples of companies with primarily Exploration and Production operations?

A Yes, he named Superior.

Q And in the North Louisiana portion of your exhibit why did you include Placid?

A Placid Oil Company is another producer who does not have refineries. And the situation is similar. Placid has a gathering system and they buy oil from other producers, move it through their transportation system and then sell it. And these are the prices they pay as a producing company with no refinery.

Q So they would not be refining any of the product; they would be selling off all of their produced and purchased crude?

A That's correct.

Q Do you know whether those two companies settled with their royalty owners at the posted field prices?

A Yes. Our company has some royalty or fee interest under some Superior properties and they ask their posted price.

MR. RAGATZ: I would like to offer Exhibit 23 at this time.

MR. MORRIS: Any objections, Mr. Shapiro?

MR. SHAPIRO: No.

MR. MORRIS: Hearing no objections, Exhibit 23 is received.

You may proceed.

MR. SHAPIRO: I will object to relevancy. I am sorry.

MR. MORRIS: You are going to object as to relevancy?

MR. SHAPIRO: Yes, sir.

MR. MORRIS: Mr. Ragatz?

MR. RAGATZ: It seems to me that one of the principal issues in this case is the integrity of the transfer prices between the E and P function and the Refining function of Humble.

The testimony of both the State's witnesses and Humble's witnesses has been that these transfers occurred and were valid at posted field prices.

This exhibit is intended to be descriptive of examples of posted field prices used to complement the testimony of this witness

as to the use of posted field prices by Humble and by other members of the industry. And on that basis we think it is highly relevant and helpful to the resolution of the issues in this case.

MR. MORRIS: Mr. Shapiro?

MR. SHAPIRO: We submit that for franchise and income tax purposes of this state, the net results of the total operations of the company represent the significant base for taxation and not the intra-department transfers or the prices at which those transfers were made. I repeat, it is the total net results of the total operation of the company under the unitary idea that we consider to be the significant matter in this case.

MR. RAGATZ: Just one further point. The evidence has already disclosed that the net profit of the E and P function of Humble figure internally determined was used by the State of Wisconsin in its calculation of the apportionment formula. And in that the value put on the crude is

perhaps the most singly important factor in determining the net profit of the E and P Department, the method by which this value was determined is highly relevant to the outcome of this case. And I would ask that the exhibit be accepted.

MR. SHAPIRO: I would like to respond to that, if I may. The net profit of the E and P Department was used for the principal purpose of separating what is situs income under the Wisconsin income and franchise tax law. Specific~~ally,~~ information was requested to make that determination and it was not obtainable. In the absence of specific and direct data from the company's records, it was essential that the functional E and P net profit be used as a base for separating the situs income derived from the income resulting from the sale of crude to outsiders as distinguished from that crude which was not sold to outsiders but which entered the unitary, as we consider to be the refining or unitary process.

MR. MORRIS: Gentlemen, Exhibit 23 is

received subject to objection of counsel
for the respondent.

You may proceed, Mr. Ragatz.

BY MR. RAGATZ:

Q I show you what has been marked as Exhibit 24 and ask you to identify that for the record.

A This is a tabulation of the Average Industry Crude Price as published by the U. S. Bureau of Mines. It lists prices in dollars per barrel for the total United States and for District V separately for the years 1960 through 1970.

Q Now would you explain further just what this exhibit shows?

A The exhibit shows that starting with 1960 the price of crude in the United States was $2.88 rising to $2.91 in 1962, then dropped to a low of $2.86 in 1965 and then started to increase and was $3.18 in 1970. The prices shown for District V followed the same pattern though the range was about 40 cents a barrel less.

Q Where is District V located?

A District V is the area west of the Rocky Mountains.

Q From what information did you prepare this exhibit?

A This was prepared from information in our files,

Bureau of Mines reports which are issued annually.

Q And was this prepared under your direction?

A Yes.

Q The purpose of this exhibit was just to show the average prices during the period in issue?

A Right, to show that there really was a decline and that prices were generally, though, flat, I would say, during the decade of the 60's.

MR. RAGATZ: I would like to move the admission of this exhibit.

MR. SHAPIRO: The same objection to relevancy is made by respondent.

MR. MORRIS: The motion to receive Exhibit 24 and the objection by Mr. Shapiro based on similar statements you made on Exhibit 23 -- Exhibit 24 is received subject to objection of counsel for respondent.

MR. RAGATZ: No further questions.

MR. MORRIS: At this time we will take a ten-minute break.

(Recess)

MR. MORRIS: You may proceed with cross-examination, Mr. Shapiro.

EXAMINATION

BY MR. SHAPIRO:

Q Mr. Jeager,during the years 1965 through 1968 your position was with the Supply Department?

A Yes.

Q And that was a corporate staff department, is that correct?

A Yes.

Q And is that the department that coordinates the supply of crude oil to the Humble refineries?

A Correct.

Q Mr. Jeager, would you distinguish between sales of crude at the lease and sales of crude by the Supply Department? How are they different?

A I guess they are really not any different with respect to the, oh, price, and the fact that crude is going to another company. There is a slight difference in the kind of contract we use, but that usually has to do with the term of the contract. At the lease the oil is delivered directly to another company's pipeline, it gathers the oil and moves it on, but at the lease the mechanism was that the Supply Department bought the oil from the Producing Department, or it was transferred to Supply and then the Supply Department signed a contract with the purchasing company. Now that procedure takes place at the lease everywhere, regardless of what is the ultimate disposition of the crude, even if the crude is being gathered by an Exxon pipeline or a pipeline company who is going to deliver it to us. Now if Exxon is going to keep the crude and it goes into an Exxon pipeline system, then after the transfer from the Production Department

to Supply, the crude is just tendered to the pipeline. If the pipeline is operated by another company, then the Production Department transfers the oil to the Supply Department and Supply makes a contract with the third party who buys the oil, and it is delivered into the pipeline -- into their pipeline.

Now there is another category of sale which would occur where we have a delivery point from our pipeline system to another company's pipeline system or to another company's refinery, and we have all of these things --

Q Yes.

A -- Where we would say sell to another company's refinery, we would have the contract which would provide for a certain amount and certain quality of crude, and by now you have a mixture of crudes in the system, and the pricing basis would be the cost of acquisition of the crude plus applicable transportation, and that is published tariffs of the pipeline, and the usual terms of time and quantities and so forth.

Q To what extent are the transactions by the Supply Department made under exchange agreement?

A These are all by sales, no exchanges. For this kind,

this domestic -- the movement of domestic crude was all by selling.

Q That was not under exchange agreement? Was cash received for a sale of the crude?

A Right.

Q From the buying company?

A From the buyer, that's right.

Q To what extent are sales of crude oil at the lease made pursuant to exchange agreement?

A There are none.

Q You mean when a sale was made, cash was received from the buying company?

A Right.

Q And did Humble have any arrangement whereby product was to be obtained from the buying company of equivalent value?

A No. You mean -- do you mean crude, equivalent value of crude to get product back --

Q Yes, yes, yes.

A No, not in these years.

Q Not in the years 1965 through 1968?

A No.

Q Were there trades or exchanges of crude oil made by Humble during these years?

A The only thing you could call an exchange would involve acquisition of import rights, wherein we would acquire the right to import crude from a refiner who had, you know, earned the right from the government under the import program, and the government relations would not permit sale of those rights, and so there was an exchange arrangement worked out by the oil import administration, which involved domestic crude and foreign crude, but those exchanges, so-called, were always an exchange of domestic crude for foreign crude and would be made at the refinery, not in the field.

Q Isn't it true that a departmental -- that no departmental profit or loss generally was recorded by the Supply Department?

A The Supply Department was not a profit center, if that is what you mean.

Q Yes.

A No, it was an administrative, and the costs were all spread out.

Q How did that come about? You stated if there is a sale of quantity of crude for cash, how did it come about that no profit was recorded if the selling price -- if no profit was recorded?

A I stated that the sale price would be the cost of acquisition plus transportation, so if you sell it for what you pay for it, there is no profits.

Q So that the profit would have been taken by the E and P Department on the transfer to the Supply Department, is that correct?

A Well, if there was one. I don't know about that, but the price we paid was the market price. Now if they produced it for less than that, I guess they made a profit.

Q Let us suppose that in a year that is within the period in issue, Humble produced 200 million barrels, and just -- 200 million barrels of crude and that 75 million were sold at the lease, and if you could keep these numbers in mind it would make it easier, which left 125 million barrels transferred to the Supply Department; now at that point is it your testimony that of the 75 million barrels sold at the lease, all of those sales were for cash?

A Well, yes, but let me correct it a minute, though. As far as the whole 200 million barrels, they would have been transferred to the Supply Department, everything produced is transferred to Supply, and then Supply is responsible for disposing of that.

If we sold it to a third party, it was under a contract and we received money for it.

Q You received money for it and there was no arrangement whereby you were to acquire from that -- from that other company, amounts of crude?

A Well, there was no related arrangement. We bought a lot of crude and a lot we bought from companies we sold to, but those were not -- they were separate arrangements for different reasons.

Q Was there any overriding arrangement at all or contractual arrangement of any kind for buying and selling as between your company and another major oil company?

A Definitely not.

Q To carry the supposition one step further, if in that example 300 million barrels were purchased by Humble, is it your testimony that all of these 300 million barrels were purchased for cash?

A That's correct.

Q And one step further, if 125 million barrels were sold by Supply, or a total of 200 million, that is 75 that we referred to and another 125, all these sales of crude would have been for cash?

A All crude sold to third parties was for cash.

Q But I would like to confine the question to total company sales and acquisition of crude.

A Well, all right; a total supply of crude was made up of the produced crude and purchases, and I am excluding imports because we are talking domestic. That all went into a pot or one big supply package from which then we sold crude to third parties and transferred crude to our refinery.

The crude that went in was categorized only by quality and in some cases location, and it had -- the only identity location was cost of acquisition which we kept a careful track of, but the total package of crude, each quality or grade that we had we knew what we paid for it and that

is the price we used when we sold it, whether it was sold to a third party or whether it was transferred to our Refining Department.

(Exhibit Number 25 marked for identification)

Q Mr. Jeager, I show you what has been marked as Exhibit 25 and are you able to identify what this exhibit is?

A Index of Crude Oil and Products Exchange Agreements.

Q Yes, sir. Now, with particular reference to Page 3, subheading 3, at the bottom of the page is entitled "Exchange of Crude Oils," and it reads in part, "To the extent of the volumes hereinafter specified, Pure and Humble shall exchange crude oils, by means of Pure delivering crude oils to Humble at Bayway, and Humble delivering crude oils to Pure at Lemont or in the field if required."

Now, with reference to that statement could you explain how that transaction came about and what relation it has to transactions in crude?

A This is a special arrangement that has been in existence for quite some time between Humble and Pure Oil Company in Chicago. It was a method that

Humble used for, if you will, transferring or supplying its products in this particular area.

Now, in effect from time to time there was some crude delivered to Pure, and Pure would deliver to Bayway, but also the products' offtake from Pure in Lemont was measured by product offtake from Pure.

When I answered you a while ago I was thinking in terms of net products to the extent that we did not have any arrangement where we put crude into another company's refinery just to get products. This was really a combination of a crude exchange and a product exchange offsetting.

Q Was the Supply Department responsible for the negotiations of a contract such as that?

A Yes, the Supply Department participated in this. This really was done before I got in the Supply Department. As I recall, the Refining Department had a major responsibility on it.

Q Then if we go back -- I would like to clarify that point. If we go back to our supposition that in any one of the years involved here a total of 200 million barrels of crude were produced by Humble, and I believe you testified that 200 million barrels would be transferred to Supply, to the Supply

Department?

A That's right.

Q Now, if a quantity of that crude oil was disposed of by the Supply Department -- I'll rephrase that question.

To what extent would the disposition of crude by the Supply Department be made under an exchange agreement posed in terms of percentage or otherwise?

A Again I say we had no crude exchanges. I guess in our operation consideration of this agreement was a special one that was somethihg that was a continuing arrangement. Actually the crude that would be involved in this was acquired on a price basis. If in fact Pure delivered crude at Bayway, there was a price established.

Q But that is an exchange agreement, is it not?

A Yes, in a sense.

Q Well, it is entitled as such?

A The title is "Exchange," that's right.

Q And my question to you was to what extent acquisitions and dispositions of crude were made by the Supply Department of Humble under similar arrangements?

A Well, there weren't any others.

Q You mean that's an exception?
A As I said a while ago, this is a special situation, and actually it was unique. There weren't any others.

There were, I guess -- there is good reason for crude being -- not being exchanged actually because of the pricing system and the fact that every crude transaction, many crude transactions involve other people, particularly at the lease.

Q To what extent did Humble have its crude oil refined by other companies?

A During these years Humble had surplus refining capacity. We refined all of our products. We had no arrangements which affect leasing in the refining capacity.

Q I take it in other years the situation was different, is that right?

A I don't recall any. We have had a surplus of refining capacity as long as I have been in Supply.

Q Might there have been other arrangements similar to the exchange agreement that you have before you that you are not aware of?

A No, there couldn't be any I wouldn't know about. I mean, there could have been some in the 50's that I wouldn't know about, but there have been none since 1960.

Q Well, now, isn't it true that Humble acquired crude over and above what it produced in order to supply the refineries?

A That's true.

MR. SHAPIRO: I will move the admission into evidence of Exhibit number 25.

MR. MORRIS: Any objection, Mr. Ragatz?

MR. RAGATZ: No objection.

MR. MORRIS: Exhibit 25 is received in evidence.

Mr. Shapiro, do you have any more cross?

MR. SHAPIRO: Yes, sir.

MR. MORRIS: You may continue.

BY MR. SHAPIRO:

Q Mr. Jeager, is it true that changes in the general level of the posted field prices are normally led by integrated oil companies such as Exxon and Texaco, Phillips?

A Oh, sometimes. No, I guess, let's talk about time. I will have to -- what period of time are you talking about?

Q Well, primarily the period in issue.

A In issue?

Q Yes, sir.

A Yeah. I guess particuarly during this time there were changes instituted by the smaller producers or by the producers only as indicated on this Exhibit 23 where Placid exchanged to Cotton Valley in August of 1967 and it was a year later before Exxon changed their Cotton Valley posting.

Q In that first column, Mr. Jeager, of Exhibit 23 under

Exxon, does the $3.30, those dashes underneath the 3.30 are they intended to mean no price change?

A That price stood for that whole time.

Q That price stood?

A That's right. Now what I quoted, if you will notice the column under North Louisiana Placid, Cotton Valley, where Placid raised their price from 2.95 to $3.02 on the 8th of August, 1967, and the 8th of August, 1968, Exxon went from $2.95 to $3.00, which was two months after Placid had gone to $312.

Now that's an indicator of what has happened in the last six or seven years. The price changes in crude has been initiated by the smaller companies, many of them in Oklahoma and Kansas where small refining companies are struggling for crude and they have initiated price changes. I guess that answers your question.

Q Humble's crude oil production was between 60 and 70 percent of its refining capacities during these years, is that correct?

A Oh, I guess. The records -- I haven't reviewed those numbers lately. That sounds right.

Q Why didn't the refineries operate at full capacity, Mr. Jeager?

A Well, there were two things that happened there during this period of time. But speaking to Humble, I forget, 1961 or 1962, we lost a big customer, Standard of Kentucky, who was acquired by Standard of California. And it was a four-year phaseout of a very large customer It was all we could do to -- in fact, one year our refinery ~~run~~ ran less than the previous year during that period. However, working as hard as we did, we put a level out, the below period.

Now during that same period of time all of the industry had surplus refining capacity. Just a matter of over building in the competitive industry.

Q Did that result from the fact that there was no market for produced crude rather than a shortage of crude or produced gasoline -- did it result from the fact that there was no market for finished product rather than a shortage of crude?

A That's correct. There was ample crude supply.

Q So the fact that there was a shortage in the Marketing Department resulted in that under refined, under capacity for refineries?

A I am not sure I follow you.

Q Can you tell the Commission what the reason was for refineries not operating at full capacity?

A The reason the Humble refineries weren't operating at full capacity was because we had lost a big customer. We had built refineries expecting a certain growth every year, expecting to participate in the normal growth of the product market or of total demand. And then all of a sudden, without warning, a large customer was taken away. Hence, the growth that we had anticipated we were not able to realize. We actually did grow in other markets, but the growth there just about offset the loss of one big customer so that our refineries' runs were level for a number of years.

I don't really know what you mean by a shortage of market except there were so many refining companies and so much crude oil to be refined that there was, the market was supplied in a competitive situation by all of the companies. And I can't answer why they over-built, but generally there was more capacity than was needed to supply the market of the 60's.

Q During this period a very modern and complex refinery was being constructed at Benicia, California, was it not, sir?

A Yes, it was built during the 60's.

Q Wasn't that supposed to go on stream about the latter part of '68 or the first part of '69?

A Yes, it was.

Q Now then, can we explain the fact that there may have been problems in not reaching full capacity for refining and yet a huge, new refinery at Benicia was being constructed?

A We have got to talk about time a little bit. I think one thing about your questions, you don't specify times and we are talking here -- I have been discussing the period of the 60's.

Q Yes.

A And not to be an economist, but I know how we look at supply problems and we were looking at growth rates. In the beginning of the 60's we had a growth rate prediction, whatever it was, and planned to meet that. And then about '61 we lost a customer. So our growth rate was flat, though we had anticipated growth; and our Refining Department was just over-built for a while. But as you proceed through the 60's, then you begin to catch up. And you are talking about 1969. Well, by then you have ten years of growth and you need a capacity.

Q In the early 60's wasn't the decision made by Exxon or Humble that more and more crude should be explored for and found and produced to meet possible expected future demands?

A Yes.

Q You mentioned that about 20 percent of the domestic crude oil is produced by independents, is that correct, sir?

A That's a rough number.

Q Yes. Isn't it also true that about 85 percent of the refineries are operated by integrated oil companies?

A Oh, I thought 85 might be a little high, but you probably got some data I don't have in mind. That's again published data.

Q Does that seem reasonable, sir?

A That's about reasonable.

Q And those integrated companies produced a major part of their own crude oil?

A Yes.

Q Is it true that the 20 largest integrated companies or crude oil production have around three-quarters of their refining capacity?

MR. RAGATZ: I would like to interpose an objection at the moment to the continued

use of the phrase "integrated oil companies" unless counsel wants to define what he means. It seems to me that's subject to varying descriptions that could be provided by an economist and not necessarily this witness.

MR. SHAPIRO: Mr. Luper, gentlemen, defined what I believe many of us considered to be a rather common useage, common-used term "integrated oil company" or "integrated petroleum company" to mean that the three major functions of Exploration and Production, Refining and Marketing are carried on by that type of company.

Is that your understanding of "integrated oil company", sir?

THE WITNESS: Oh, I heard his testimony, yeah. I still don't claim to be able to describe or define an integrated oil company.

MR. MORRIS: We will be off the record for a minute.

(Discussion off the record)

MR. MORRIS: You understand Mr. Shapiro's question, the original question that was asked?

Mr. Shapiro, would you repeat the question, your original question, or do you wish it read back?

MR. SHAPIRO: I would like it read back.

(Question read)

MR. MORRIS: Do you understand the question?

THE WITNESS: No, I don't really.

MR. RAGATZ: Mr. Commissioner, I would like to pose another objection. I think the inquiry now has strayed pretty far afield. I don't see the relevance of that line of inquiry to the operation of Humble Oil and Refining in relation to the issues here, so I would also interpose an objection on the basis of relevancy.

MR. MORRIS: Mr. Shapiro.

MR. SHAPIRO: The witness testified as to a percentage of the domestic crude

oil that was produced by independents. Now he is referring to a segment of the industry, and that is what we are also inquiring about in our question.

MR. MORRIS: I will allow Mr. Shapiro to continue the line of questioning subject to objection of counsel for the petitioner, but again getting back to the original question I think it was the 20 integrated oil producers is what was suggested. You heard the reporter read back the question, and do you understand the question?

THE WITNESS: I don't understand the part --

MR. SHAPIRO: I am not sure it came out right on the read-back.

MR. MORRIS: Would you repeat your question?

MR. SHAPIRO: Yes, sir.

BY MR. SHAPIRO:

Q Do the 20 largest integrated oil companies have crude oil production of around three-quarters of their refining capacity?

A You mean domestic crude oil production?

Q Yes, sir.

A I don't have the data, but I doubt it.

Q You doubt it?

A Yes.

Q What would your response be in terms of a percentage?

A The ~~company~~ country is importing about a third of their requirements now.

Q I didn't hear you.

A They are importing about one-third of their requirements.

Q I am referring to the years in issue.

A Well, in those days imports were about 12 per cent of the national requirements, but the major companies were running all of the imported oil, so I just don't know whether 75 is a good number or not.

Q Wasn't it Humble's objective during this period that we are concerned with to increase oil production by -- say between 1960 and 1970 by 50 per cent and to narrow the gap between its production and refinery capacity?

A Oh, I don't recall any such objective.

Q Might that have been an objective that you are not aware of?

A Well, the thing you are talking about might have

been some statement or something. Basically it certainly was an aggressive company in the production business; they are always trying to increase their production. It is -- it could have been an objective. I just don't recall any such statement.

Q Now if they are trying to increase their production, it is necessary to have refining and marketing facilities to carry out the disposition of that production, isn't that true?

A No.

Q How else is crude oil disposed of unless it is converted by refinery and sold on the market?

A Well, you have about 10,000 independent producers that have no market -- well, you have 125 refining companies -- you have probably 25 to 50 refining companies that have no production in the United States.

Q But isn't it true that the large integrated oil companies,of which Humble was one of the largest, accounted for the major production of crude oil in the United States?

A I don't know what you mean by "major," but you make it sound awfully big.

Q Isn't it awfully big?

A Sir, it is big, yes.

Q I have no further questions at this time.

MR. MORRIS: Redirect.

EXAMINATION

BY MR. RAGATZ:

Q Mr. Jeager, you were asked on cross-examination about whether the so-called integrated oil companies led in changing the postings. Would you comment on whether or not during the years in issue Humble was a leader in changing posted field prices?

A Humble was not a leader during those years.

Q No further questions.

MR. MORRIS: Mr. Shapiro.

MR. SHAPIRO: No further questions.

MR. MORRIS: Any reason for this witness to be held over for any further testimony?

MR. RAGATZ: Not on our --

MR. SHAPIRO: No.

MR. MORRIS: Therefore this witness is excused and this hearing is adjourned to 1:30 this afternoon, and we will reconvene in this courtroom.

(Noon recess, 12:00 - 1:30 p.m.)

AFTERNOON SESSION

MR. TIMKEN: Are we ready to proceed, Gentlemen?

Mr. Ragatz?

MR. RAGATZ: Yes.

MR. TIMKEN: Mr. Shapiro?

MR. SHAPIRO: Yes, sir.

MR. TIMKEN: Mr. Ragatz, I believe you are ready to call another witness.

MR. RAGATZ: The petitioner calls John Carter.

JOHN CARTER,

called as a witness, having been first duly sworn, under oath, testified as follows:

EXAMINATION

BY MR. RAGATZ:

Q Will you state your full name for the record.

A John J. Carter.

Q Where do you live, Mr. Carter?

A I reside at 5213 Valerie Street, Bellaire, Texas.

Q How old are you?

A Sixty-five.

Q Would you review your educational background for us, please?

A I graduated from Bowling Green College of Commerce in 1932 with a B. A. in Commerce, and immediately following graduation from college I worked about 10 months at a small cooperative training as an accountant, and then went to Houston to teach business law and accounting in a business school, and I was there for about 10 months, and then in 1934 I went to work for Humble Oil and Refining Company.

Q What professional societies do you belong to?

A I belong to the Natural Gas Men of Houston. I have an individual membership in the American Gas Association. I was on the Board of Directors of the Independent Natural Gas Association of America for the last two years of the time when I was with Humble.

Q Have you had any government services?

A Oh, I overlooked -- I haven't had any government service, but for about six years prior to the time that I retired from Humble I was the Secretary of Interior Emergency Advisory ~~Adversary~~ Committee for Natural Gas, and I have worked before the Federal Power Commission on cases that we had before the Federal

Power Commission.

Q Presently are you retired?

A I am retired, yes, sir.

Q What was your occupation before you retired?

A Immediately before I retired I was a senior advisor to the General Manager of the Natural Gas Department, but that was from August 1st, 1972 until my retirement on November 1st, '73, but prior to that I was the General Manager of Humble's Natural Gas Department,and I stepped down in 1972 in anticipation of normal retirement on November 1st, 1973.

Q What other positions have you held prior to being Manager of the Natural Gas Department?

A Well, all my experience with Humble was in natural gas. I started work in the Natural Gas Department in 1934 as a clerk in the Gas Department and came up through various occupations in the Gas Department to finally Manager of the Gas Department and General Manager of the Natural Gas Department.

Q How many years of experience did you have in the oil and gas industry?

A I had 39½ years of experience with Humble and 10 months with another cooperative refinery, so nearly 41 years.

Q In your position as General Manager would you describe your duties and responsibilities?

A Well, as General Manager of the Natural Gas Department my responsibility was management of the sale and purchase of gas for the Humble Company, for the Production Department.

Q Where did the Natural Gas Department fit into Humble's organization structure?

A We are the Headquarter's Department, , but our prime function is to sell gas for the exploration and production function and to purchase such gas as they might purchase so we were in effect a service organization to the Production Department.

Q Was the Natural Gas Department accounted for as part of the exploration and production function?

A All of our expenses were rotated to that function, yes.

Q Now, was the Natural Gas Department a separate profit center?

A No.

Q A separate investment center?

A No, sir.

Q On what function's books were carried all the plant and physical equipment of the Natural Gas Department?

A You mean all the producing facilities of the company and plants?

Q Correct.

A That was all the Production Department's books.

Q Did this include the gas plant?

A Yes, sir.

Q Were the gas plants another step in a separation process of the raw gas?

A Yes, and the plant was a part of the producing operation.

Q To your knowledge did any of the natural gas go to the Refinery Department for product conversion?

A For product conversion?

Q Correct.

A None for product conversion, no.

Q Did any go for fuel consumption for the Refining Department?

A There was gas that went to the Refining Department for fuel and heat.

Q Of the total natural gas, what percentage would you say went for fuel consumption by the Refining Department?

A In the period that we are talking about here, a little over 4 per cent.

Q What was the primary function of the Natural Gas Department?

A To sell gas was the primary function. Of course, we had a lot of other dealings that were related to that, but our prime function was to sell gas.

Q Did you purchase any gas, too?

A Yes, sir.

Q What did Humble do with the gas it produced?

A Consumed it in that operation, and sold it.

Q Where was this gas sold off?

A Well, all the gas that we sold was sold in the state in which it was produced. It was sold in the field at the individual well or it was sold in a central point in the field or it was sold at the discharge of the gaseline plant or on the Texas Coast. We had a small industrial gas system that we serve industry along the Texas Gulf Coast and some was sold to industry through the industrial system.

Q How much of what was sold was purchased gas?

A Oh, a very small percentage, 3 per cent, something like that. Most of it was our own gas that was sold.

Q And because of the purchased gas, was Humble a net seller of gas?

A We definitely were a net seller of gas, yes.

Q What functional department got credit for the income from these gas sales?

A The Production Department.

Q I would like you to refer to Exhibit 20 which was introduced and identified during the testimony of Mr. Luper. I'm sorry, it is Exhibit 21.

Can you point out on that exhibit where the producing areas are for natural gas in this country?

A All of the states with the diagonal lines drawn across them are states in which we had gas production at that time.

Q And which were the states where your principal gas production was?

A The principal gas production, Texas, Louisiana and Mississippi, Oklahoma and New Mexico.

Q And where were the sales made of the gas produced in each of the states?

A All gas that we sold was sold in the state where it was produced.

Q In each case?

A In each case, yes.

Q What activities did the Natural Gas Department have in the State of Wisconsin, if any?

A We didn't have any.

Q There were no production activities?

A No.

Q And no sales activities?

A No, sir.

Q And no purchase activities?

A No.

Q And no utilization of gas for any purpose internally?

A No, sir.

Q How was the selling price of the gas determined on sales to third parties?

A Negotiated, it was negotiated prices.

Q And how was the purchase price determined when you were buying gas from third parties?

A On the same basis. Gas contracts are negotiated on a negotiated basis, both purchase and sale.

Q How was the gas valued for purposes of Humble's internal deliveries?

A Still on third party contracts. In our job in the Natural Gas Department one of the things that we had to do was to keep up with the market situation so we attempted to keep abreast of the market situation and our transfer prices were determined by use of third party contracts that we could obtain

information on, so we could keep current and in line with the going prices in the areas that we were talking about.

Q What were some of the characteristics of the negotiated third party contracts?

A Well, most of your gas contracts are long-term contracts. They usually are 20 years. Many contracts -- we didn't write many, but many contracts were even for the life of the lease where gas might be found, but generally they were all long-term contracts, more normally 20 years.

Q How was the price set in these contracts?

A The price was established by negotiations.

Q Were there escalators or ajustments to the price?

A The contracts usually provided for fixed step escalation; some for price redetermination. Everybody was trying to negotiate the best deal. The seller was trying to get the best deal and the buyer was trying to do the same thing so it was a matter of straight negotiations.

Q What did the contract generally say as to quantity?

A It specified the quantity as to how the gas was to be taken, and, of course, the producer and seller wanted the quantity to be as large as possible, and

the buyer had to be careful and not overburden themselves with gas he couldn't use, so when you started negotiating a gas contract price, that was just one of the things that was negotiated. The term was also negotiated, the quantity, the quality, who was going to pay the taxes. All these kinds of things were just part of the negotiations that were carried on.

Q Now, with whom would Humble normally be contracted, what kind of customers?

A Principally intrastate pipelines; that is pipelines that move gas across state borders; that is pipelines that purchase gas in the state and sell it in that same state; and then we serve industrial customers along the Texas Gulf Coast. We were serving them with Texas gas, and that is the three principal types of contracts that we made, big contracts.

Of course, we made contracts with other producers where we would buy some gas from another producer where it was going into the gas plant, but these three are the principal types of contracts that we made.

Q Now, how did the delivery points of gas affect the

prices?

A Again, delivery points or the delivery point is negotiated under the contract, but if there was extensive delivering involved, the producer could usually get a better price for the gas by taking it to a central point, but the better price he got was just about enough to offset the transportation, the transportation costs that he had to incur at the central point; so the difference between the central point delivery and the well head delivery would be the transportation costs.

Q In addition to these negotiated third-party contracts, what other sources of competitive price information were available to you?

A Well, in Texas where our most extensive operations were, all of the purchasers of the natural gas have to file a report with the State Comptroller; and once these reports are filed with the State Comptroller, they are public information. And on these reports it shows the volume of gas that the purchaser is buying, who he is buying it from and the amount of money that he paid for the purchaser and where the gas was located. So we could get these purchaser's reports from the State Comptroller and we get a pretty good fix on the price of gas in the various areas.

In addition, a considerable portion of gas in Texas moves in interstate commerce, or Louisiana too moves in interstate commerce. And all contracts where gas moves in interstate commerce has to be filed with the Federal Power Commission in Washington. These contracts are public information once they are filed with the Federal Power Commission. So we could get price data from those. And then it was our responsibility in the Natural Gas Departments to try to keep up with markets. So our men that were mixing

around in the industry tried to get the best information that they could get, too, on what the markets were.

Q What kind of information could you obtain from the information on file with the Federal Power Commission?

A The contract itself was filed with the Federal Power Commission and it would show what the practice was, what the volume was,where the gas was located, who was the seller and who was the buyer and the quantity had to be taken, what the quality of the gas had to be, and all of those kind of things was entered into the contract. And it was just part of the contract.

Q Now in what situations did you need to determine internal transfer prices within Humble?

A Well, for gas going into our industrial gas system we needed transfer prices there because the gas was transported from the lease through their system to the industrial consumers on fixed contracts. But in order to settle with the royalty owners and settle with the production taxes with the State of Texas, we had to set a fair price on the gas that was going into the system; so we needed it for that.

The Production Department in its field operations used considerable amount of gas for field

operations for heater treaters, operating compressors and such things as that. And we still had to value that gas for those purposes. And we had to establish prices for the gas that goes to the Refining Department although the way we established price going to the Refining Department is the transfer of price to the Production Department to the Refining Department was to use in most of this period that we are talking about now, we were selling gas to another refinery, a large quantity of gas to another refinery for the same purpose that Exxon was using the gas for. So our refinery was charged the same price that the other purchaser was charged.

Q Maybe you have already answered this but I am going to ask you anyway how the internal transfer prices were generally determined for any refinery?

A Well, that's what I said, I believe. They were set all in relation -- The information that we got from the Comptrollers Department were all third-party contracts. Third-party contract data. Those prices and everything were right there from third-party contracts and, of course, what we were primarily interested in the transfer price was the pricing, but we could tell about the volume too because the

volume showed up in that report.

Q Now were these the same prices at which, when you purchased gas, you were purchasing it at?

A Yes. Our prices had to be competitive if we bought any gas.

Q Now was the portion of the gas income of Humble's E and P Department from internal transfers derived by use of these field prices?

A Yes, sir. That's where the production for that part that was consumed within the company, that's where the Production Department's income was derived from. Those prices were used in arriving at the income for that gas.

Q And you commonly refer to those prices as field prices?

A Field prices and the transfer ~~of~~ price to the refinery. The field price is the well price, the well head price. The other transfer price was the one to the refinery which didn't relate to the field.

Q But it was determined the same way?

A It was what?

Q Determined in the same way?

A It was determined by a third-party contract.

Q So then the prices of the gas on sales to third parties

were based upon actual contracts negotiated with the third parties?

A They were based on actual contracts that had been negotiated by someone with third parties.

Q And the transfers internally by Humble were based upon the same criteria, the same contracts?

A Well, in the period that we are talking about here, they were based on contracts that we had negotiated with third parties there, one with the refinery that you mentioned. And when that contract terminated, then we switched over to another contract of similar quantity and just about the same related price. So they were still tied into a third-party contract.

MR. RAGATZ: No further questions.

MR. TIMKEN: You may cross-examine.

EXAMINATION

BY MR. SHAPIRO:

Q Mr. Carter, do you get, I should say, does the company get crude oil and natural gas from the same wells?

A Yes, sir. Let me qualify that. That is one source. There are some that you don't get both, but we do get crude oil and natural gas from the same well.

Q Will you please describe for the Commission each of the

steps involved in bringing the natural gas out of the ground up until the time it is delivered to the purchaser?

A Well, it would be a layman's description. Now I am not a technician so I can't go into all the technicalities of it. But using the type of gas that you are talking about where there is oil and gas that is produced from the same well, as the oil and gas comes out of the well, it goes into a separator. The separator lets the gas go off the top and goes into the pipeline and the oil comes out of the bottom and is separated and goes to the lease tank.

Now that's just simple but, as I said, I can't go through all of the technicalities of it because I am not a technical man.

Q And that's with reference to the gas coming out of the same wells as the crude?

A Yes.

Q And what is the other?

A If it would come out of the gas well, it would be a similar operation, except in the first one that you are talking about is primarily oil and gas is secondary. If you get over into a gas well, it would be primarily gas with the condensite being secondary.

Q What is the function of a gas plant?

A It's to extract additional liquids out of the natural gas.

Q And how close to the well or wells is the gas plant located?

A Well, that would vary. Some of them are in the field, some of them -- You can't say any definite thing because there is hundreds and hundreds of plants and they are, all of the wells, in different locations. Generally it's close to the field where you process the gas.

Q And what is done with the liquid extracted from the natural gas?

A Well, I can't be specific as to that with the liquids that are extracted. It all depends. Certain plants extract different degrees of liquid. Some of them extract only the natural gasoline, others going to natural gasoline, butane, propane and some of them go on up and get methane and liquified ethane out of the gas. So the disposition of it, each plant just -- ~~d~~ they dispose of whatever their production was. But it goes into the market place.

Q And how do they liquify it? Can you answer that?

A No. I think you are getting out of my range now.

Q These derived products that you referred to are used or sold or could you explain that a little more?

A Yes, sir. They are useable products. When they are extracted, they are extracted for the purpose of getting into the market place.

MR. SHAPIRO: Can we have five minutes?

MR. TIMKEN: Surely. We will take five minutes.

(Recess 2:00 p.m.)

MR. TIMKEN: Back on the record.

Mr. Shapiro?

EXAMINATION

BY MR. SHAPIRO:

Q Mr. Carter, are these liquefied products that are derived from the natural gas transferred to the Marketing Department for sale?

A You know, I don't know whether I can answer that in the period we are talking about here. The Production Department handled the plant's products for the early period of the time, and it was a change that took place in there and I just can't answer when it did take place.

Q But somehow they got into a marketing channel for sale?

A Some of them may have, but I am just -- I didn't have anything to do with it, so I don't --

Q From your general understanding, if they weren't destined for sale, what was done with the liquefied products?

A Well, I know the Production Department -- they liquefied ethane, they liquefied ethane and before they could go after ethane they would have a market

for it to some chemical company.

Q So it was sold?

A It was sold, it was utilized, yes, sir.

Q I have no further questions at this time.

A Yes, it was sold.

MR. TIMKEN: Any redirect, Mr. Ragatz?

EXAMINATION

BY MR. RAGATZ:

Q On that same point, Mr. Carter, was it the Production Department that made the sale in those situations?

A In the early days they did. More recently I can't -- that is what I say, I can't give you an answer on that.

Q But the pattern has been that the Production Department itself would make the sales of these gas plant products?

A Yes.

Q You were asked about the function of the gas plant; is it or is it not a further separation of the natural gas on a more sophisticated level, but analagous to what goes on in the original separator at the well head that separates the oil from the gas?

A It is similar to it, but it is more elaborate.

Q Now, one other question: of the total produced and purchased gas by Humble, how much of it was sold to third parties?

A Well, I don't know that I could give you an exact percentage, but of course gas is something you don't store. When you produce it, it has got to go right into the market there. I say you don't store -- you can store it, but there wouldn't be any point to a producer producing it and putting it back in storage. When he produces it, he wants to market it, so we marketed all of the gas we didn't use in our own operation, so I would say it was 88 per cent of it, or something like that, with the other 12 per cent -- 8 per cent of it being used by the Production Department and 4 per cent being used by the Refining Department.

Q No further questions.

MR. TIMKEN: Any re-cross?

MR. SHAPIRO: No, sir.

MR. TIMKEN: Mr. Carter, you are excused. Thank you.

(Witness excused)

MR. TIMKEN: You may call your next witness.

MR. RAGATZ: The petitioner calls Donald A. Campbell.

DONALD A. CAMPBELL,

called as a witness, having been first duly sworn under oath, testified as follows:

EXAMINATION

BY MR. RAGATZ:

Q State your full name for the record.

A Donald Arthur Campbell.

Q Where do you live?

A Houston, Texas.

Q How old are you?

A Forty-five.

Q Would you review your educational background, please?

A I have a Bachelor of Chemical Engineering Degree from Georgia Tech.

Q What is your present occupation?

A I am a staff Commerce Advisor in the Supply Department.

Q Of what company?

A Exxon.

Q How long have you been with Exxon and its predecessor?

A Twenty-three years.

Q Would you briefly review the history of your employment as to the various positions you held during that time?

A Yes. When I left school I went to work in a refinery in Baltimore and I was there for approximately six years, and I transferred to the Marketing Department and I was in Marketing for 10 years, and the last seven years I have been in the Supply Department.

Q How many total years of experience do you have in the oil and gas industry?

A Twenty-three.

Q What are you duties and responsibilities in your present job?

A In my present job I have the responsibility east of the Rocky Mountains for the exchange of products, whether they are finished products or intermediate streams in the refinery, the setting up of exchanges, whether they are for a long term or spot arrangements to cover emergencies, and I also buy product when we need product, and I sell when we have surpluses.

Q Are you familiar with the publications called "Platt's Oil Gram" and "Platt's Oil Price Handbook"?

A Yes, sir.

Q Would you describe them, please?

A Well, Platt's Oil Gram is a two-section news service put out by McGraw Hill that has a news service covering the items of interest in the news as they relate to the petroleum industry, whether they be domestic or foreign, they cover such items as Congressional activities, various pronouncements by oil companies on expansion projects and that type of nature, and the news service repeats certain items of news, I mean the price service covers certain items of news, but primarily reports on the market prices of various products at various points in the United States.

Q Now this is the Oil Gram, I take it?

A Right.

Q What is the Platt's Oil Price Handbook?

A The Platt's Oil Price Handbook is a yearly summary of the daily reports.

Q Is that published in book form?

A Yes, sir.

Q Now just what prices are reported in these publications?

A The publication reports prices on all types of products and they report at various locations,

depending upon the normal type of sales that are made at that point, at the refineries, and at the ocean terminals they report prices related to ship cargoes or barges or pipelines, and at the various rack locations at the inland terminals, they report the prices of products in the truck.

Q These refinery prices and rack prices, is that what you commonly think of as the wholesale price level for products?

A Yes.

Q How many products are covered by the reporting services?

A There must be 45 or 50. I have never counted them.

Q How are the prices determined that are reported by Platt's?

A In most of your rack prices in your land terminals, your price is a price that is posted by the companies that were selling at that point. On your Gulf Coast cargo price, it is almost an editorial-type price today. At one time the companies did post what price they would sell a cargo of gasoline, but today the editorial staff through their various news sources finds out at what prices various products are being sold.

Q Are these prices between unrelated buyers and sellers?

A Yes.

Q Are they prices at which products are actually changing hands?

A To the best that they can report, they state that they do not change these prices unless they have evidence that product has moved at those prices.

Q How long has Platt's been publishing these publications?

A They have been in business since 1934, I think.

Q And how frequently are they published?

A Every working day.

Q Is that the Oil Gram?

A That is the Oil Gram and the news service.

Q How frequently did you say the Handbook was published?

A Once a year.

Q Did you or your department during your years in issue regularly review the Platt's Oil Gram?

A We review the Oil Gram every day.

Q I have here a sample copy of a Platt's Oil Gram, which I would like you to identify, but with permission of counsel for respondent, I would like to put a Xerox of that into the record instead of the original, in that they are supposed to take the

original back to Houston.

(Exhibit 26 marked for identification)

BY MR. RAGATZ:

Q Would you describe what has been marked as Exhibit 26, please?

A This is the March 1, 1966 edition of the Platt's Oil Gram, it has both the news service and the price service sections.

Q And just for purposes of illustration, would you point out where the Gulf Coast prices are shown?

A On the back page, which is Page 6A of the price service, and on the Xerox I guess it is still the last page of the Xerox, just about one-third of the way up from the bottom it shows, "GULF COAST-CARGOES, ALL PORTS, FOB SHIP."

Q Just quickly, what relation does that price category have to product moving into the State of Wisconsin in Humble's operation?

A Well, in Humble's operation it is directly related to the price of product moving into Wisconsin.

Q Explain the use of those prices, would you, please?

A Well, during the time period involved, products were sold between the Refining and the Marketing Department

based on a formula tied to the posting in Platt's, and it was a discounted formula based on the history we had had of our third-party sales to Standard Oil of Kentucky.

These prices are a day-to-day type price and historically if someone wanted to make a long-term contract or a large contract, they could effectively negotiate a discount off of this price, and that is how we established our transfer price to Marketing from Refining.

Q What kind of circulation does this publication have, if you know?

A Within Humble or within the industry?

Q Within the industry.

A I suspect it is the most widely-read publication in the industry.

MR. RAGATZ: I would like to offer Exhibit 26 in evidence at this time.

MR. TIMKEN: Any objection, Mr. Shapiro?

MR. SHAPIRO: No objection to the exhibit other than it affecting the respondent's audit insofar as transfer prices are concerned, I believe it may

relate to the same objection we previously made with respect to transfer prices as not being relevant to our apportionment formula.

MR. TIMKEN: Exhibit 26 is received.

MR. SHAPIRO: Subject to the objection?

MR. TIMKEN: Subject to the objection.

BY MR. RAGATZ:

Q Mr. Campbell, do your duties relate to acquisition of products for sale to the public by the Marketing Department?

A Yes, sir.

Q Where do you obtain these products?

A Well, from all sources. If we need product, I go to the people in the industry who I think have surplus product for sale and try to arrange for a purchase.

Q Did any Humble refined fuel products go to marketing in Wisconsin during the 1965-1968 period?

A No, sir.

Q Where did you obtain the products which were sold in Wisconsin during that period?

A There were two sources. The majority of the products was received on the Pure exchange out of Lemont, Illinois, and the balance was a small purchase that we had with the Great Southern Refining Company up in Junction City.

Q Where is Lemont, Illinois located generally?

A It is on the west side of Chicago, the best I can remember.

Q This morning a copy of the Pure exchange agreement was introduced into evidence as Exhibit 25, and I wonder if you might comment first in clarification as to the crude oil exchange aspect of that agreement based upon your understanding of the arrangement in connection with your duties.

A The crude oil arrangement was established back in the late 50's when the government first imposed the import program and started issuing quotas. It was an arrangement whereby Pure was anxious to get the imports into the system and made the arrangements with

Exxon so they could bring in foreign crude to use their foreign tickets, and we gave back crude as was designed to go back up to Lemont.

Q This was related to that special situation import ticket arrangement that Mr. Jeager described?

A Yes, sir.

Q During the years in issue were there any other crude oil straight exchange agreements to your knowledge in this country?

A None other than these that were set up to take care of the quota situation.

Q Other than this foreign quota situation you don't have any crude exchange?

A No, sir.

Q Explain briefly the product exchange aspect of the Pure agreement, if you would.

A The products exchange portion of that was set up at the time Humble was expanding in the Midwest market, and we were trying to develop a way to get products into the Midwest market.

Pure, who had more refining capacity than they had marketing requirements in the Midwest, was anxious to find a way to get products to the East Coast so in effect we set up a products exchange

where they gave us products in Chicago and we returned products to them at Bayway, New Jersey.

Q Now, when the Supply Department acquired products from Pure and transferred them to the Marketing Department, what price was used?

A The transfer price for these products was based upon the third-party sale contract number that we talked about earlier, the discounted Platt's price plus the location differential which reflected the cost of moving the product from the Gulf Coast to Chicago, and on that, whatever pipeline costs or terminal costs were required to get it into the trucks where marketing could use it.

Q Was there also a discount factor?

A Oh, yes.

Q Would you describe that?

A The discount factor was one which was established, I guess, around 1961 or possibly '62 and negotiations between marketing and refining were based on the history of the Standard Oil of Kentucky contract. It was decided a discount of 24 ~~cents~~ or 25 ~~cents~~ points a gallon would be given to the sales between ~~from~~ refining, ~~sales to~~ marketing.

Q This was a discount applicable on Platt's price?

A Yes.

Q What was this contract with Standard Oil of Kentucky?

A That was the contract where -- well, for years Esso, Standard Oil and then Humble was selling products to Standard Oil of Kentucky.

Standard Oil of Kentucky was an independent marketer marketing in five states in the Southeast and we sold them the majority of their products.

Q Was there any corporate affiliation between Standard Oil of Kentucky and Standard Oil of New Jersey or Humble?

A No, sir.

Q Standard Oil of Kentucky was a separate independent company?

A Yes, sir.

Q Did the price as set, as you just described, fluctuate during the period 1965 through 1968?

A Constantly.

Q And how did you keep track of this price then, or maybe you could describe the fluctuation.

A Each day as Platt's was published, if there was a change in the cargo price of Platt's on that day, the transfer price to marketing would change to reflect the change in Platt's.

Q So it directly followed or correlated the changes in Platt's?
A Right.
Q How was the price determined in situations where no Platt's price was available?
A There has never been a time that I have been aware of that there hasn't been a Platt's price.
Q Now, Platt's relates to your principal product, I take it?
A Yes.
Q What about minor products where Platt's doesn't have a quotation?
A The minor products I think you are referring to are the greases and waxes and the motor oils, and Platt's does have some basis for that, but generally these are proprietors' products that are blended up to meet specific formulas and have certain additives.
Q Did you have other sales of comparable products to third parties that you could refer to for pricing?
A Only the base stock which are covered in Platt's.
Q This would enable you to make a buildup and determine the price for the product?
A It gave you a starting point of the arguments between refining and marketing.

Q Was there a buildup on the basic price between refining and marketing for transportation and terminal costs?

A Was there a buildup; yes, the transfer price to marketing was also set at a base point at the refinery tail gate and from that point the cost was built up to reflect what actual costs took place or what change location differential was involved and so forth.

Q Now, as to transportation into Wisconsin from Lemont, did that occur in Humble-owned pipelines?

A No.

Q Were the terminals in Wisconsin owned by Humble?

A No.

Q So the third parties involved in setting the transportation and terminal costs were added as buildup to the price?

A Yes, we negotiated with them, but not by pipelines. They had posted tariffs, but for the terminal fees.

Q Was there also a buildup for the price fuel additives?

A The additives in the State of Wisconsin were products not coming from directly our refinery. The additives were shipped up to the terminals on a separate basis, injected at the rack. These costs were

paid by marketing as an addition to their basic costs and the transfer price to marketing reflected the products that they received and did not include the additives.

Q Who actually determined at what price the transfers would be made between refining and marketing?

A Once the negotiations were completed on the basic transfer price, which was related to Platt's, that set the cost of getting the product to other locations. If it was an exchange, like all of the material going into Wisconsin was done, that was done by the negotiations that I or my predecessor made with the exchanging company to get products at that point.

Q How did this procedure carry out the Humble policy of functional profitable independence?

A It maintained that the marketing was paying a price comparable to what they would have had to pay if they were going on the open market to buy from another refinery.

Q How did this procedure affect the ability of both marketing and refining to be competitive with independent marketers and independent refineries in the industry?

A Well, from the refining standpoint, the price that

refining was getting from their products was comparable to what an independent refinery would get if they were selling products on an open market on daily prices, and it also gave marketing the same base point from which to operate as if an independent marketer had gone on the open market.

Q Were the products that Humble acquired from Pure at Lemont refined from Humble-produced crude oil?

A I don't believe so.

Q What was the major purpose of that exchange agreement as to products that you already described?

A The major purpose of ~~the~~ any exchange ~~agreement~~ is to reduce the cost of getting products from the normal production source to the point ~~of where~~ at which it is sold.

Q Is there any real difference between the exchange as you operated it and a purchase or sale of the product?

MR. SHAPIRO: Objection; calling for a legal conclusion.

MR. TIMKEN: Objection sustained.

MR. RAGATZ: If I might, the question I am attempting to ask the witness relates to his experience of the operation of the exchanges. I am not intending to ask for a legal conclusion as to whether there is a

legal difference between an exchange relationship and from his operation of it. I think I should be entitled to ask him whether there were any mechanical differences.

MR. SHAPIRO: It doesn't have that implication.

MR. TIMKEN: Maybe you can rephrase the question, Mr. Ragatz.

BY MR. RAGATZ:

Q Do you in your department handle purchases and sales of products as well as exchanges?

A Yes, sir.

Q Now, in the mechanical operation of an exchange, is the procedure different on an exchange than if you were purchasing or selling?

A Yes, there are two basic differences.

Q Will you describe them?

A Well, purchase and sale are not necessarily related and most generally are not. You purchase and pay cash for the product you sell or you sell and collect cash for the product you deliver.

On an exchange the arrangement is set up so that the only money that changes hands is the differential in the location or the quality of

deliverance and the basic value of the product is exchanged for in kind rather than a dollar value being exchanged and dollars changing hands.

Q Other than the differential for quality and location, the exchange would be a purchase paid for in kind?

A It could be set up that you would make a complete purchase for the product that you received and then a complete sale of the product you are delivering, but there are two problems. One, you have a lot of money changing hands, and, two, you sort of lose control over the exchange portion of the operation if you don't work it on a balanced basis.

Q Is the exchange process a common process in the industry?

A Yes, sir.

MR. TIMKEN: Back on the record.

Mr. Ragatz?

BY MR. RAGATZ:

Q Mr. Campbell, when and where did Humble obtain title to the products which were transported to Wisconsin for sale?

A The products in some cases, the title was transferred at Lemont, Illinois on those that we arranged for shipment up through the West Shore Pipeline and others were obtained. We obtained title as they were loaded in the trucks. This is the fuel products, the main products we are talking about.

Q I think I already asked you whether these pipeline charges for transportation to locations in Wisconsin were incurred to Humble on the pipelines?

A Yes, you asked me that and the answer was no.

Q How were the product prices determined at the tail-gate of Pure's Lemont refinery?

A The prices were determined based on our formula for the base transfer price at the Gulf Coast locations and then we added to that the location differential to get up there.

Q This is the same procedure you previously described?

A Right.

Q Was it necessary to determine prices to account for imbalances under the exchange agreement with Pure?

A The only time that would be necessary would be at the end of the year if it was an imbalance in the exchange; and in order to reflect that in the inventory the price would be assigned to the product but that would be the same value as any other barrel that was in the refinery at the time.

Q And the prices would also be set in relation to Platt's? Same manner?

A Yes.

Q Now were all of the refined fuel products which the Supply Department acquired and transferred to Humble's Marketing Department priced for transfer purposes at a third-party price set in relation to Platt's?

A No, sir. The small amount that we purchased from Great Northern was transferred to Marketing at the price we were able to negotiate in our purchase from Great Northern.

Q But other than that were they all set in relation to third-party prices?

A Yes, sir.

MR. RAGATZ: No further questions.

MR. TIMKEN: You may cross-examine.

MR. SHAPIRO: Thank you.

EXAMINATION

BY MR. SHAPIRO:

Q Mr. Campbell, is your position with the company in the Supply Department?

A Yes, sir.

Q Certain characteristics of gasoline affect the performance of an automobile, isn't that true?

A Yes, s ir.

Q For example, starting and warm-ups, vapor lock, are controlled by the hydrocarbon composition of the gasoline?

A Yes, sir.

Q Now, fuel economy, engine knock and carburetor icing are controlled by a combination of hydrocarbon composition and fuel additives, are they not?

A Repeat the three again?

Q Fuel economy, engine knock and carburetor icing are controlled by a combination of hydrocarbon composition and fuel additives?

A Right.

Q In 1967 did Humble develop a carburetor detergent

additive to reduce maintenance and operating costs?

A We have a constant research program going on. I don't know what years they --

Q An additive does have some effect in eliminating emission pollution, does it not?

A Yes, sir.

Q Did you develop an additive known as HTA?

A Yes, sir.

Q And was that during the period in question?

A That was much later, I believe.

Q Might it have been as early as 1968?

A No, I think it was '70 or '71, I think, before HTA came out. I may be wrong.

Q Now you considered HTA, this additive, as improving the distribution of gasoline to the individual cylinders of the engine and as a detergent, didn't you?

A It had many uses, yes.

Q Are such additives of Humble made available to other oil companies? They are patented, are they not?

A Yes, sir. I believe this one was.

Q So that is it true that the formulas are known only to Humble?

A I really can't answer to that.

Q Is a significant part of research and development devoted to improving the quality of gasoline?

A Yes, sir.

Q Now an automobile gets better mileage with a heavier gasoline, isn't that correct?

A Right.

Q However, starting and warm-up is more efficient with a lighter gasoline?

MR. RAGATZ: I would like to interject to object on the basis that this seems pretty far afield and I question the relevance; and I guess I would like to submit an objection based upon the relevance of what all this mechanical, technical stuff after the years in issue has to do with the issues in this case.

MR. TIMKEN: What are you trying to develop, Mr. Shapiro?

MR. SHAPIRO: We are not dealing with the years after the years in issue here, sir. What we are describing for the Commission, to make the record as complete as possible, are characteristics of the principal product of this company, gasoline.

And certainly if that's not relevant, I don't know what is.

I would like to add, Gentlemen, if I may, that, as I think I may have indicated before, the principal issue in the case is unitariness and unitariness cuts across the entire operation of the company. And for that reason also I submit it is relevant.

MR. TIMKEN: Mr. Shapiro, we will allow Mr. Ragatz, and Mr. Shapiro, we will allow the witness to answer these questions but not as to product that were produced outside of the years in question.

MR. SHAPIRO: Very good.

BY MR. SHAPIRO:

Q In blending a gasoline, Mr. Campbell, is it not necessary to sacrifice or trade off certain qualities, for example, to get maximum mileage you must reduce the starting and warm-up characteristics?

A Yes, sir.

Q The blending process in Humble refineries is accomplished with the aid of computers, is it not?

A It is today.

Q Was it in 1968?

A I don't know when we first put our first computer in. I don't think it was in '68.

Q Are seasonal variations taken into account, that is, is a different gasoline manufactured for winter than that manufactured for summer?

A At our refineries the gasoline qualities are changed daily.

Q So that there are finer variations taken into account?

A Yes, sir.

Q For example, when the company is marketing gasoline in Illinois or Wisconsin where seasonal changes in temperature occur fairly rapidly, does the time lag in delivery from refinery to service station cause problems at times, that is, in connection with planning for changes in temperature?

A No, sir. We have divided the country up into about 35 or 40 different zones from a temperature standpoint and when products are produced at the refinery to be moved to those zones, the time lag associated, whether it is a pipeline movement or a barge movement, and the normal amount of time to go through the terminal before the product is delivered to the

service station is taken into effect and back calculated in one month as to what the qualities are going to be required when it's actually sold.

Q Do those different geographic areas require different blends of gasoline?

A Yes, sir.

Q Did the octane ratings increase during the years in issue?

A I don't recall.

Q If they might have increased, this would have resulted from a variety of complex and costly refining processes, isn't that true?

A Not necessarily.

Q What would it result from?

A You can change the octane level of gasoline just by the quantity of lead that you put into the product and also by a change of the component you use to blend the particular gasoline.

Q Is the gasoline produced by one of Humble's refineries the same chemical mixture as that made by another company?

A It wouldn't be exactly the same; it would be generally the same type of ingredient.

Q That is before the additive package is put in?

A Yes, sir. But we all have different goals we are shooting for as to what mixture we want between start-up and mileage and so forth.

Q Your operations include quality control or monitoring of your gasoline which is sold by the dealer, doesn't it?

A Yes, sir.

Q Does Humble sample the gasoline in order to assure, to have assurance of quality?

A In most areas we have relied on the ethyl survey which, up until just recently, has picked up samples from service stations all over the country. In those areas where ethyl was not picking up samples, we had our own programs for picking them up.

Q So that is done at various points in the distribution point in the distribution system?

A Yes, sir.

Q Does Humble have product standards covering such octanes as volatility, vapor pressure stability, lead content and uniformity of quality?

A Well, the last one comes by the enforcement of the standards of the first ones, yes, sir.

Q Is the purpose of quality control to assure that the gasoline sold under Humble's trademarks meets quality

standards?

A Yes, sir.

Q And the goodwill that's associated with it?

A Right.

Q Do the additives used by Humble require special equipment and efforts for mixing into the gasoline?

A No, sir.

Q Is the additive a rather thick substance that would tend to settle at the bottom of a storage tank if it were merely dumped in?

A Not if it's made right.

Q At what point in the distribution system is the additive mixed into the gasoline?

A For a refinery-produced gasoline the additives are mixed in at the refinery. For product that's picked up at the exchange location, it is injected into the gasoline at the loading rack.

Q Is the additive packaged, is it placed in certain containers?

A It's generally shipped to the exchange areas in drums. In small locations it can be shipped in small cans that will be the right size for a particular compartment on the truck.

Q Is it manufactured by Humble?

A Not always.

Q But in some cases?

A Some cases. Not by Humble itself. I guess there is a distinction between Humble and the other affiliates.

Q The additive is a composition of chemicals resulting from the company's R and D, isn't that right?

A Yes, sir.

Q And did you answer the question as to whether it's covered by the patent?

A I said I didn't know.

Q Do you have any knowledge as to whether it might be covered by the patent?

A Well --

MR. RAGATZ: I think I got to object. He asked the witness the question, the witness said he didn't know and then he asked the same question again.

MR. TIMKEN: I think that's right, Mr. Shapiro. Objection sustained.

MR. SHAPIRO: All right.

BY MR. SHAPIRO:

Q The gasoline received from an exchange partner is refined according to Humble's specifications, isn't it?

A It's either refined according to Humble's specifications or it meets certain basic criteria that we have to have before we will accept exchange gasoline.

Q I believe you testified that additives are injected at the rack. Can you spell out exactly what the rack' is?

A The rack is the position in a terminal where a truck pulls under and it's called the rack because it looks like a framework. And a truck pulls under and the loading iron comes down and the gasoline is poured in the truck and there are projectioneering pumps set up at that rack and as you push the button the additive injection pump is also activated and injects an additive at the same time, and that would have been the situation in Wisconsin.

Q Are there basically two types of exchange agreement, long-term and short-term?

A Yes, sir.

Well, the same type of agreement. There are two types; some run for long periods and some are for short.

Q Is the long-term agreement more significant and widely used in your company?

MR. RAGATZ: Objection. I don't

understand what he means.

Q Is the long-term agreement more widely used in your company than the short term, one to three years, say?

A To my knowledge we have never had an exchange agreement that ran as long as three years. We have done some checking recently and we make more spot short-term exchanges on a yearly basis than the continuing type you are referring to.

Q I believe you testified that an exchange results in the savings of transportation costs, is that correct?

A Yes, sir.

Q There is a considerable time lag between the manufacture and the use of gasoline, isn't that right?

A It can run --

Q Up to 30 days?

A It could be that long in certain terminals, yes.

Q Now this time lag between refinery and the consumer means that the refiner must plan very carefully for the manufacture of the right type of fuel, is that right?

A Yes, sir.

Q And if the weather is unusually warm or unusually cold this may create problems?

A Yes. The basic blending formulas are set up based

on a 20-year average of what the weather has been and that's continually reviewed and updated so that we can have the best -- we can predict, based on the average of weather. And you get Indian Summer or a cold snap in the South, you can have problems.

Q Is there another problem to overcome as the result of this time lag and that is to prevent the gasoline from adversely changing characteristics during this period?

A The stability controls that are built into it would keep it from changing characteristics.

Q Is there a tendency for some components of the gasoline to combine with the oxygen in the air to form gum or varnish?

A That is one of the tests we control for.

Q And is this tendency slowed down by additives called antioxidants?

A Yes, sir.

Q Do some metals act as a catalyst and tend to speed up this process?

A Would you repeat that question?

Q Well, are there additives that are called -- I will rephrase it.

Are certain additives called metal

deactivators?

A Yes, sir.

Q What do they do?

A To the best of my knowledge if a certain sweetening process is used in the refinery that you can come up with some chemical forms in the gasoline that would react with certain type piping or tank walls and these metal deactivators control that so you don't get the inter-reaction between the gasoline and the metal that it comes in contact with.

Q Since the gasoline must be transported, stored and delivered, what housekeeping methods are used to avoid getting dirt, rust and water in the gasoline?

MR. RAGATZ: I am going to object again to the relevance of this. Anybody who markets gasoline or refines it is going to try to keep it clean. What possible relevance does that have to this proceeding?

MR. SHAPIRO: I am not going to develop this much longer but these are important questions.

MR. RAGATZ: I will stipulate that they try to keep it clean. How about that

to save time?

MR. SHAPIRO: I just don't think you like the questions for other reasons.

MR. TIMKEN: Gentlemen, I will concede I have trouble seeing the relevance of these questions also; but I don't think we should cut Mr. Shapiro off. Perhaps he will be able to develop them. But I do agree with Mr. Ragatz that I don't see the immediate relevance, Mr. Shapiro. But I am going to allow you to continue irregardless of that.

Q Since the gasoline must be, Mr. Campbell, transported, stored and delivered, what housekeeping methods are used to avoid getting dirt, rust and water in the gasoline?

A It is a conventional-type operation where there are spot checks made, samples taken at various points in the production and in the transportation operation to make sure that there hasn't been contamination, and since you are generally using facilities that have been set aside for the sole purpose of moving the gasoline and so forth, the chance of outside dirt and so forth getting in are very remote.

Q So that good performance of the gasoline to the consumer is the end result of a long chain of events to insure quality control, isn't that right?

A Yes, sir.

Q How many departments of the company have you worked with, sir?

A I have worked with Refining, Marketing, and Supply.

Q Do you know of other instances where key employees are transferred from one department to another?

A It is quite frequently.

Q I have no further questions.

MR. TIMKEN: Mr. Ragatz?

EXAMINATION

BY MR. RAGATZ:

Q I don't want to dwell on this, but I think maybe for the record I would like to ask you whether independent marketers look for particular quality in the gas they acquire?

A The independents have certain criteria they look for just like everyone else.

Q Do they worry about the mixture of the gasoline as applied to weather or season conditions?

A Oh, yes.

Q Do they worry about the cleanliness of the gas?

A Certainly.

Q The performance of the gas?

A Certainly.

Q How about independent refineries? Do they use the same or similar protective ingredients and procedures as Mr. Shapiro asked about?

A Yes, sir.

Q Do they work for quality control?

A Certainly.

Q Cleanliness?

A Yes.

Q Good performance?

A Yes, sir.

Q No further questions.

MR. TIMKEN: Mr. Shapiro, any re-cross?

EXAMINATION

BY MR. SHAPIRO:

Q These efforts that are generally referred to by Mr. Ragatz extend over the entire company, do they not? Quality control and so forth?

A Well, quality control starts at the time of refinery trying to manufacture the product to meet certain specifications right through the transportation operation to keep the quality that was built into it and marketing to make sure that the same quality gets to the service station, yes, sir.

Q I have no further questions.

MR. TIMKEN: Thank you, Mr. Campbell. You may step down. You are excused.

(Witness excused)

MR. TIMKEN: Mr. Ragatz, you may call your next witness.

MR. RAGATZ: The petitioner calls Robert Koonce.

ROBERT KOONCE,

called as a witness, having been first duly sworn under oath, testified as follows:

EXAMINATION

BY MR. RAGATZ:

Q Would you state your full name for the record.

A Robert Dean Koonce.

Q Where do you live?

A Pasadena, Texas.

Q How old will you be on Thursday?

A That is irrelevant.

Q Will you please answer the question.

A Forty.

Q What is your educational background?

A I have a high school equivalency, 1954, and I received an BA degree from Lee Junior College in 1962, and a BBA degree from the University at Houston in 1966.

Q Would you describe your employment history.

A I have worked for the past eight and a half years for the Humble Oil and Refining Company, and prior to that I worked for Goodyear Tire and Rubber Company for almost twelve years, and then I was in the Marine Corps for about two and a half years.

Q Would you describe the duties of your present position?

A I supervise the filing of state income and franchise tax returns and federal tax returns.

Q And how long have you been in this position?

A I have been in a supervisory position for about three years.

Q What is your precise title?

A I am a Senior Tax Specialist.

Q What was your involvement with Mr. Sheridan's audit of Humble for the years 1965 through 1968?

A At the time of that audit I was assigned the responsibilities for filing the Wisconsin Franchise Tax Return and I worked with Mr. Sheridan during the field audit.

Q Are you familiar with Exhibit 1, which has been admitted into evidence in this proceeding?

A I am.

Q And that constitutes the Notice of Assessment letter and accompanying audit report?

A It does.

Q And that is the audit report by Mr. Sheridan that you just described?

A That's correct.

Q Can you describe Mr. Sheridan's conclusion in his transmittal letter that accompanies the audit report in terms of whether or not the company was considered as a unitary business with its Wisconsin operation as an integral part --

A I can read for you this letter. Okay, it says that, "The additional tax results from a change of method of reporting income to Wisconsin. Since Humble Oil and Refining Company is a unitary company and its Wisconsin business is an integral part thereof, formula apportionment of the company's income is mandatory and separate accounting is not permissible."

Q When did you first learn of this conclusion?

A When Mr. Sheridan came into our office.

Q And approximately when was that?

A February of 1970.

Q And if you know, how close was that to the time he commenced the audit?

A That was when he commenced the audit.

Q And upon what do you base the belief that he had reached the unitary conclusion at that time?

A Well, he did not want to audit the separate accounting returns. He said that that didn't make any difference, since we were unitary, that he was going to perform the audit similar to the audit that had been performed by Mr. Kaspar.

Q Are you familiar with the document called the "Longhorn paper" which has been admitted into evidence in this proceeding as Exhibit 11-12-B?

A I am.

Q I show you that exhibit and ask you to describe particularly the latter parts of it?

A It is an outline of certain questions that apparently are supposed to be asked in the determination -- in making the determination as to whether a company is a unitary business.

Q Prior to the time this document was produced for us in January as part of our discovery proceeding, had you ever seen this document?

A Not with this cover on it. I have seen a document similar to this outline which was produced after the suit had already been filed in Wisconsin.

Q And the commencement of the audit or at anytime during the audit, did Mr. Sheridan discuss with you the factors that are set forth in the Longhorn paper?

A He did not.

Q Now to clarify again, when did you say you saw a document similar to that Longhorn paper?

A In about January of 1972 Mr. Sheridan was in Houston conducting another audit, I guess, and he came by and asked us to answer the questions in a document similar to this.

Q Was that the first time he asked you for such

information?

A That's correct.

Q And when had his audit been completed?

A His audit had been completed in May of 1971.

Q And if you know, when had this present case been commenced.

A I think suit was filed in December of '71.

Q Now on what basis had Humble reported the results of its operations during the years 1965 through 1968?

A It had filed its Wisconsin returns on the basis of separate accounting.

Q Was this consistent or inconsistent with its prior reporting processes to the State of Wisconsin?

A It was consistent.

Q Would you explain the reporting pattern beginning in 1956?

A Well , in 1956 the Pate Oil Company, which was subsequently merged into Humble Oil and Refining Company, was operating wholly within the State of Wisconsin and filing its returns on the basis of separate accounting, and after the merger in July of 1960, Humble continued to file its returns on the basis of separate accounting.

Q During this period, say, from 1960 on Humble was operating the Wisconsin operations of the former Pate Company. Were separate accounting records maintained as to Wisconsin sales and expenses?

A Yes, they were.

Q Was a record of Wisconsin sales maintained in the Milwaukee District Office?

A A record of these sales were so maintained.

Q Were all these sales made to outsiders?

A They were.

Q Other than a minor reconciliation as just described, did Mr. Sheridan dispute the amount of sales reported?

A He did not.

Q Did Mr. Sheridan challenge the reported cost of goods sold?

A He did not.

Q Was the cost of goods sold as reported consistent with Humble's books and records?

A The cost of goods reported was taken from Humble's books and records.

Q Was the cost of goods sold determined from third-party prices in the method described by Mr. Campbell?

A I believe that to be correct.

Q Were the same methods used to determine the cost of

goods sold for other states in this geographical area?

A They were.

Q How were the operating expenses determined which we deducted on Wisconsin returns?

A Most of the operating expenses were determined by a state code that was assigned to these expenses, and specifically identified with the State of Wisconsin.

Q Now, I show you one of the returns for the four years in issue; this being 1967, and ask you if you can identify for me any expenses claimed thereon as deductions which were not separately recorded on your books and records?

A On Page 1 of the 1967 return, the advertising expenses were not separately maintained as to Wisconsin, and the area and administrative expenses set forth on Schedule 1 of Page 4 of the return were not specifically identified with the State of Wisconsin.

Q Now, was the same true for the other three years in issue?

A That's correct.

Q And were these the only expenses allocated to the State?

A These were the only operating expenses that were

allocated to the State.

Q And how were these allocations determined and from where were these expenses allocated?

A These expenses were allocated on the basis of the sale realization method taking Wisconsin sales to the total; for example, area sales to get a percentage and were multiplied to the area expenses and that part of the area expenses were assigned to Wisconsin.

Q Was this method of allocation to Wisconsin any different than allocations to any other states in the region?

A It was not.

Q Was the accounting for these allocations consistent each year?

A It was.

(Exhibit 27 marked for identification)

Q I show you what has been marked as Exhibit 27 and ask you to identify what that represents.

A This is a summary of the operating expenses allocated to Wisconsin for separate accounting purposes.

Q Was this prepared at your direction?

A Yes, it was.

Q Would you describe what this exhibit shows?

A This exhibit shows that what expenses were allocated to Wisconsin and for two of the years, 1966 and 1967, it shows that if all of the allocated expenses were disregarded, we would still have a loss, and for 1965 if 60 per cent of these allocated expenses were totally disregarded, we would still have a loss, and for 1968 if you disregard about 85 per cent, you would still have a loss.

Q Now, were the figures on this schedule taken from the company's tax return as filed in Wisconsin?

A They were.

MR. RAGATZ: I would like to move the admission of Exhibit 27.

MR. TIMKEN: Any objection?

MR. SHAPIRO: No objection.

MR. TIMKEN: Exhibit 27 is received.

BY MR. RAGATZ:

Q Based upon your understanding and your familiarity with the accounting records of Humble, were the expenses as reported on the Wisconsin returns including those allocated as accurately as possible reflect these expenses attributable to Wisconsin?

A They were.

Q Would you repeat what would have been the result

even if these expenses would have been eliminated in the returns in substantial part for each of the years in issue?

A As I stated before, if you eliminate for 1966 and 1967 all of these expenses, you still have a loss, and if you eliminate most of the expenses for 1965 and possibly '68, you still have a loss.

(Exhibit 28 marked for identification)

Q I show you what has been marked Exhibit 28 and ask you if you can identify that.

A I don't know how you want me to identify it.

Q Explain what it is.

A If you turn to -- I guess I can explain it by the table of contents.

MR. RAGATZ: I wonder if before we do this we might have a recess?

MR. TIMKEN: We will take ten minutes.

(Recess)

MR. TIMKEN: Back on the record. Mr. Ragatz, you may proceed.

BY MR. RAGATZ:

Q I believe just before we broke, I handed you an exhibit what's been marked Exhibit 28. And would you explain what that document is?

A That document is a summary of alternative methods of attributing income to Wisconsin to demonstrate the substantial overreach of the State's hybrid apportionment formula.

MR. SHAPIRO: I object to the conclusion contained in that statement. It certainly is a conclusion, an"overreach".

MR. TIMKEN: I think the witness can answer, Mr. Shapiro. You can certainly cross examine him on his choice of words. But you in effect are not objecting to the question but you are objecting to the answer.

MR. SHAPIRO: I didn't know the question would provide that answer.

MR. TIMKEN: Well, I think you can explore that on cross examination if you so desire. I am afraid I will have to

overrule the objection to the answer.

BY MR. RAGATZ:

Q Where were the figures shown on the schedule contained in this exhibit obtained?

A They were obtained from the audit report and from Humble's books and records.

Q And do they constitute a summary of figures shown in Humble's books and records?

A They do.

Q And did you prepare this summary?

A I prepared part of it and part of it was prepared under my supervision.

Q Were the books and records from which the summary was prepared maintained in the ordinary course of Humble's business?

A They were.

Q And were these books and records prepared contemporaneously or within a short time after the transactions they reflect actually occurred?

A That's correct.

Q Do you have the original record computer runs from which these summaries were prepared in court today?

A I do.

Q Now are these two boxes of books those computer runs?

A That's correct.

Q Let the record show the witness is referring to two large cardboard containers containing books. And I show you one of these books as an example; and would you explain what that book contains?

A This is a computer run of Humble Oil and Refining Company's separate company 1965 federal income tax return.

Q And are the other books contained in the two boxes just mentioned similar runs for other years?

A They are similar runs for the other years during this audit.

Q And what other kind of computer run records are contained in those boxes?

A Our assets by state records, computer runs are contained in those boxes.

Q And do those boxes contain all of the figures necessary to support the figures contained in this Exhibit 23 Schedule other than, of course, the State's figures that are also reflected in here?

A These boxes together with the audit report are my sources for preparing this .

Q Did Mr. Sheridan, during the course of this audit, have a full opportunity to examine the company's

books and records?

A He did.

Q How much time did he spend in Houston if you recall?

A Oh, I'd say a little better than three weeks or so.

Q All of this was on the audit of Humble?

A That's correct.

Q And what was the time span of the total audit?

A Let's see. The audit commenced in February of 1970 and we received the assessment notice I believe in May of 1971.

Q Now referring again to these books and records were they kept under your supervision or that of your Department?

A They were.

Q Were they physically maintained in your Department's office in Houston?

A They were.

Q And did you cause them to be brought here today?

A I did.

Q Now would you look at Schedule A in this Exhibit 28 and would you explain this summary shown of Schedule A?

A Well, the summary that's set forth on Schedule A is the summary of alternative methods of attributing

income to Wisconsin. The first two sets of columns represent the taxable income and the tax obtained by use of the State's hybrid apportionment formula.

The second set of columns sets forth the net losses and tax, zero tax, for Humble's separate accounting Wisconsin operations. The third set of columns sets forth the taxable income and the tax if you apportion the marketing function within or without Wisconsin and with the allocation of specific items under the law.

And the fourth set of columns represents the apportionment of combined marketing and refining income within and without Wisconsin with the allocation of certain items under the law. And the last set of columns represents the treatment of the Exploration and Production Department as a separate business or as allocation to situs under the law with the other allocable income allocated to situs as provided by the law the balance of the income apportioned under the law.

Q What was the reason for preparing alternative taxable income and tax calculations?

A Well, because of the complex nature of the State's formula, it was about the most vivid way that I could

think of to demonstrate the overreach of the State's method.

Q Now would you compare for the Commission the results aggregated for the four years of using the state's hybrid apportionment formula compared with the results of Humble's separate accounting reporting?

A The difference between those two methods?

Q Uh-hum.

A The difference in taxable income between the state's hybrid apportionment method and Humble's separate accounting return, there was a net change in income of approximately eight and a half million ~~billion~~ dollars with a tax of $316,000.

Q All right. Now let's turn to Schedule B. And since we looked at the 1967 return, let's turn to the 1967 Schedule B? Would you explain what this Schedule shows?

A This schedule sets forth each of the Department's taxable income for the year 1967.

Q And these figures reflect the manner in which your books and records are kept?

A They do.

Q And so that each functional department has its separate set of records?

A That's correct.

Q Now were the books and records of each department maintained consistent with the policy of functional profitability independence?

A I believe that to be correct.

Q And these figures shown in this schedule for 1967 show the results of those operations on the company's books and records?

A That's correct, with the tax adjustment.

Q Now what was the purpose of preparing this Schedule B?

A The purpose of preparing this schedule was to demonstrate that our federal taxable income is calculated by departments.

Q Now in preparing the separate departmental profit and loss schedules what transfer prices were used on crude oil transferred from the Exploration and Production function to the Refining Department?

A Posted field price.

Q And were the transfer prices used between the Refining Department and the Marketing Department consistent with the procedures described by Mr. Campbell?

A I believe that to be correct.

Q And was the transfer value of natural gas transferred between Exploration and Production and Refining

consistent with the procedures described by Mr. Carter?

A I believe that to be correct.

Q And you indicated that posted field prices were used on the transfer from E and P to Refining and was that consistent to the procedure described by Mr. Jeager?

A That's correct.

Q Now were the accounting procedures consistent in each of the years in issue as to each of these departments?

A They were.

Q So that each of these Schedule B's contained in this exhibit reflect what the books and records show as to the departmental profit or loss for each of the four years in issue?

A That's correct.

Q Now were the results of each functional department's operations evaluated by the company on the basis of their functional operating statements?

A I believe that to be correct.

Q Did the Wisconsin Department of Revenue review the results of the functional accounting?

A No, they did not other than the auditor reviewed

the federal return from which these numbers were taken.

Q Now in the course of the audit and subsequent assessment of Humble for the years in issue, did the Department respect the integrity of Humble's functional net profit determination as to any function?

A They did.

Q Would you explain that?

A Well, one of the calculations in the audit report involves taking the Exploration and Production Department income and determining what part of that is considered under their interpretation as being allocable to situs and being in the nature of income from mining. And the balance of the income was treated as apportionable with the allocation of certain specific items.

Q Now can you point out in the State's audit report, which is Exhibit 1 in this proceeding where the net profit of the Exploration and Production Department was used?

A It's set forth on Exhibit E-4-1 of the audit report.

Q And let the record show that you are now referring to the document that's been admitted into evidence here as Exhibit 1?

A That's correct.

Q What figure is shown for 1967 as the net income of the Exploration and Production Department?

A Two hundred and fourteen million, two hundred twenty-eight thousand, nine hundred fifty-one dollars.

Q And would you point out where that same figure appears on your schedule B?

A It's the bottom number in the first column of figures on Schedule B -- 1967, Page ~~1011~~ 1 of 1.

Q Now referring again to the same page of Exhibit 1 do the figures for the E and P net profit correlate with your schedule as to each of the other years?

A They do.

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Q Did the State in any way make an examination to test the integrity and validity of the transfer prices between E and P and Refining which were used to arrive at that E and P net income?

A Not to my knowledge.

Q Did the State dispute in any way the functional accounting as to any other function?

A Not to my knowledge.

Q And did --

A Except they made some kind of adjustment for administrative expense, but that's all.

Q Did the State in any way make an examination to test the integrity and validity of the transfer prices between Refining and Marketing functions?

A It did not to my knowledge.

Q Now in addition to E and P, Refining and Marketing, Schedule B shows other functional operating departments. Would you explain how the company treated each of these other departments?

A Each of these other departments are profit centers and they are treated as -- as if you would treat a separate business for a Marine Department, and also for the Coal and Shale Oil Department, Minerals Department and Land Management Department.

Q Would you explain the relationship of the Coal and Shale Oil Department to Minerals and the Land Management Department to the location of the operations that each conducted?

A Well, the business that was conducted by the Coal and Shale Oil Department has previously been explained as the Exploration and Production for coal and shale oil, and those expenses in 1967 were incurred at the situs of where those operations were conducted.

Q Was there any production or mining of coal and shale oil in any of the years in issue?

A I don't believe so.

Q Would you make the same explanation relating to the Minerals Department?

A Well, the Minerals Department is the department which operates the business of exploring for and producing, if mines are found, hard minerals, and the expenses applicable to these operations are incurred at the situs of those operations.

Q Was there any production or mining of minerals during the period here in issue?

A Not to my knowledge.

Q And would you make the same description as to the Land Management Department?

A Well, the Land Management Department has the responsibility of operating the business of disposing of surplus property for the company in the most efficient manner possible, and those operations have to do with property that is located within a particular state or area and their site of operation.

Q Do you know whether Land Management had any Wisconsin properties sold during the years in issue?

A I believe that there was one during this period.

Q And do you recall whether or not that was reported as income allocable to situs on the Wisconsin returns filed?

A It was.

Q Now during at least one of the years in issue, Schedule B shows a column for Enjay, and will you describe what that is?

A Enjay for 1965 and the first part of 1966 was the department within Humble that operated the chemical business of Humble Oil and Refining.

Q Did that business have any Wisconsin activities?

A Some small minor sales.

Q Were those sales reported on the Wisconsin return?

A They were.

Q Now will you explain how Mr. Sheridan's audit treated

each of these departments?

A I hope I can. The Exploration and Production Department, as I -- are you talking about just these latter departments or all of them?

Q No, just the minor departments?

A Okay. The Marine Department was treated in the audit report as being the net income from the -- the Marine Department was treated as partly allocable and partly apportionable, and the allocable part arose from the chartering of vessels to third parties and was treated as rental income allocable to situs.

The Coal and Shale Oil Department results, with the exception of any minor items that were adjusted in the audit report, the balance of it was treated as apportionable, and the same is true with Minerals, Land Management and Enjay.

Q Did you provide the auditor with separate profit and loss figures on each of these departments?

A I did.

Q I believe I asked you as to Enjay and Land Management, but did Marine have any operations connected with the State of Wisconsin?

A Not to my knowledge.

Q And did Coal and Shale Oil have any operations

connected with the State of Wisconsin?

A Not to my knowledge.

Q And how about Minerals?

A Not to my knowledge.

Q According to Mr. Luper's testimony, the E and P function is composed of three departments, Exploration, Production and Natural Gas. How are these treated for accounting purposes?

A All three of these are treated as one profit center, as the exploration and production data on this exhibit demonstrates.

Q You are referring to Schedule B of Exhibit 28?

A That's correct.

Q And that exploration and production column then constitutes the combination of those three --

A The business conducted by the exploration and production function.

Q Now do each of the functional operating departments have their own accounting personnel and maintain their own separate records?

A They do.

Q So each has its own accounting department then?

A Yes, they do.

Q And for what purposes are the figures of all of these

functional operating department combined?

A They are combined only for purposes of preparing company-wide financial statements and preparation of the federal return.

Q Otherwise are they separately maintained?

A They are.

Q And is it or is it not true that each functional operating department has a full complement of accounting staff?

A They do.

Q Now let's go back to Schedule A of Exhibit 28, and would you explain the alternative approach shown on this schedule where only Humble's marketing function was apportioned?

A Well, the third set of figures on Schedule A reflect the taxable income and the tax that would result from apportioning the marketing functions income within and without the State after allocation of those items that are required to be allocated under the law.

Q Why did you make this particular calculation?

A Again, this was an approach to demonstrate the overreach of the State's hybrid apportionment formula.

Q Would you point out the difference between Humble's separate accounting reporting and the result of

apportioning marketing only?

A Humble's separate accounting returns reflected 3.9 million dollar loss for the four-year period as compared to taxable income produced of approximately 2.1 million dollars, if you apportion the marketing income within and without the State and allocate certain items to situs, that is a net difference of about six million dollars.

Q And how can you explain that difference?

A That difference has to do with innerplay of the apportionment formula, in that all of the Marketing Department's income is apportioned uniformly by the use of this apportionment formula without regard to where the incomes are.

Q Well, would you explain the impact of the different kinds of marketing areas on the result that you get in that calculation?

A Well, what you do is, through the use of the apportionment formula, as testified by Mr. Luper, we have expansion areas in our Marketing Department and we have mature areas, and these expansion areas are operating at a substantially less profit than the mature areas are realizing, and through the use of the apportionment formula you shift that income from those mature areas to the expansion areas.

Q Would you compare the difference between the results on this calculation that is apportioning marketing only and the result reached by the State in reaching its hybrid apportionment formula?

A There is, an indicated by the little B on Schedule A, the net difference between this calculation and the State's average calculation demonstrates an average of approximately two and a half million dollars of income under this theory.

Q Does that mean that even if you assume that the marketing function should be apportioned, ignoring the difference between expansion areas and mature areas in marketing, that even assuming that, the State's application of the hybrid apportionment formula still produced two and a half million dollars for income?

A That's correct.

Q Does Humble agree with the approach of apportioning marketing only?

A It is an alternative ~~that~~ but we think our separate accounting return more properly shows our income attributed to expansion transactions in Wisconsin.

Q Would you explain Schedule D on Exhibit 28?

A Exhibit D?

Q Correct.

A Schedule D contains the calculations that support the summary that we were just looking at over on Schedule A, and we have started off with the Federal Taxable Income applicable to the marketing function. We have adjusted that to the Wisconsin basis and deducted these other deductions that are provided by law, and then allocated these items that are required to be allocated under the law.

Then on Page 2 we have calculated a factor using the marketing attributable within the State , the total marketing attributable and a portion of the apportionable income on page 1 within and without the State based on that formula using the three factor formula as provided by law.

Q The result then is the taxable income and tax as shown on Page 1 of Schedule D which would result if you only apportioned marketing?

A That's correct.

Q And these results are reflected back --

A On the summary on Schedule A.

Q Now, would you explain the next alternative where

refining and marketing are combined?

A Schedule A, the four set of figures on Schedule A reflect the taxable income and tax that would be generated by combining the Refining and Marketing Departments' income and apportioning it within and without the State under the law and allocating -- after allocation of these items that are required to be allocated.

Q Would you explain the difference in the results of that approach as compared to separate accounting?

A Well, Humble's separate accounting returns reflected a net loss of 3.9 million dollars for the four-year period and under this approach it would produce taxable income of about 1.9 million so that there is a net swing of about 5.8 million dollars.

Q And how do you account for that kind of a difference in addition to what you have explained already in connection with the marketing function?

A Well, the difference is further explained by the interplay of each function's income, and the interplay of the proprotionate share that each of these functions contribute to the factor attributes which have an effect of uniform~~ity~~ly distributing this income without regard to where it is earned.

Q Why did you make this calculation, combining marketing and refining?

A Well, I made it to further demonstrate the substantial overreach of the State's hybrid apportionment formula.

Q Does the company keep combined records on marketing and refining?

A They do not.

Q Does the company agree with this approach?

A It is an alternative, but we think that our separate accounting return more properly reflects our income from operations in the State of Wisconsin.

Q Now, would you explain Schedule E on Exhibit 28?

A Schedule E is the calculation of the information that is set forth on the four set of figures on Schedule A and on Schedule E we have combined the Marketing and Refining Departments' income, federal taxable income, converted it to a Wisconsin basis, taken these deductions that are provided by law and allocated that income which is required to be allocated, and the balance of the income is apportioned within and without Wisconsin based on the formula that is obtained on Page 2.

Q Now, were the Marketing Department's figures maintained on the policy of functional profitability

independence?

A That is my understanding.

Q And adjusted to the Wisconsin basis?

A That's correct.

Q Were the Refining Department's figures maintained on the policy of functional profitability independence?

A That's my understanding.

Q And adjusted to the Wisconsin basis?

A That's correct.

Q And for purposes of Schedule E, you have combined the figures of the two departments?

A That's correct.

Q And then computed the taxable income on the basis of the statutory apportionment formula?

A That's correct.

Q And these figures on the bottom of Schedule E are reflected on the summary of Schedule A?

A That's correct.

Q Would you describe the difference between the result of that calculation and the result of the State's hybrid apportionment calculations as reflected on this audit?

A The net difference between the State's hybrid apportionment calculation -- the taxable income is

approximately four and a half million dollars. These calculations produced taxable income of about 1.9 million dollars and there is about 2.6 million dollars overreach of income outside of the State of Wisconsin.

Q All right. Now, while we are still talking about marketing --

(Exhibit 29 marked for identification)

Q I show you what has been marked Exhibit 29 and ask you if you can identify and explain what that is?

A This is a comparison of net income from the Marketing Department with the assessed income from the Wisconsin marketing operations.

Q Was this prepared at your direction?

A It was.

Q Where did the figures shown on this exhibit originate?

A The first two sets of figures were taken from the audit report and the second set of figures, other than the percentage figures, were obtained from the Marketing Department's books and records.

Q Were these the same books and records we previously described?

A That's correct.

Q Would you describe the relationship shown on this exhibit?

A Well, for the four-year period, the percent of assessed taxable income per dollar of Wisconsin sales was approximately 7.5 percent whereas the Marketing Department's net income on the Wisconsin basis, the percent of that to the Marketing Department's sale overall was approximately 3.2 percent.

Q Then according to the State of Wisconsin, the operation in Wisconsin earned over 2 and one-third times the dollar sales as did the whole marketing function?

A That appears this is what this means.

Q Now, considering the separate accounting results and the methods that you described and your background with Humble, do you know of anyway Humble's marketing operations could have earned two and one-third times per dollars of sales as did the whole marketing functions?

A I believe it has already been established that Wisconsin is an expansion area which is less profitable; as a matter of fact, it operated at a loss over this period as compared to some mature marketing areas

which produced substantial income, and that even these facts would even further distort this relationship between these two numbers, and that 3.2 percent on here assumes that all the marketing sales produced proportionately the same amount of net income.

Q Instead of taking Humble's marketing sales and total marketing income converted to the Wisconsin basis, you broke that down between mature marketing areas and expansion marketing areas. Would you describe the relationship between the resulting percentages for expansion marketing areas as compared to the Wisconsin taxable income for the state audit.

A Well, the expansion areas, because they are less profitable, , the percent of net income per dollar of sales would be substantially less than the overall marketing, and if you took the mature areas, then those percentages would be substantially higher than this average percent, and maybe more in line with the number that is shown on this other relationship part of the audit.

MR. TIMKEN: Mr. Ragatz, is this a convenient place to break?

MR. RAGATZ: I would like to move the admission of this exhibit before we stop.

MR. TIMKEN: 28 and 29?

MR. RAGATZ: I am only ready at the moment to offer 29.

MR. SHAPIRO: We will object to the relevancy of that exhibit because this approach is again the functional approach taken by the company whereas the respondent submits that a more valid comparison would show Wisconsin sales, Wisconsin's net income total company sales and total company net income.

MR. RAGATZ: I would like to point out that respondent is free to offer any comparison that it thinks is valid, but it is part of the presentation of our case that we think that the contrast shown by this exhibit is highly significant and very clearly demonstrates the overreach of respondent's method.

The relationship of Wisconsin's taxable income in an expansion area of two and a half times the total company's marketing net income very vividly demonstrates how far the state is reaching. We think this is

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very relevant to the issues, whether the State's application of its apportionment method can be sustained or whether it violates either statutory or constitutional, or both requirements.

MR. TIMKEN: We will receive Exhibit 29 for what it is worth subject to respondent's objections, and before adjourn I would just like to say for the record Mr. Shapiro raised some questions of terminology. I would like to explain to both parties that the words used such as "hybrid" and "overreach" are the petitioner's descriptive words and their description of what happened. This, of course, will not control our decision obviously.

Anything further today; if not, we will adjourn until 9:30 tomorrow morning.

(Proceedings adjourned)
(4:30)

STATE OF WISCONSIN | WISCONSIN TAX APPEALS COMMISSION

* *

EXXON CORPORATION, (f/k/a Humble Oil and Refining Company),

Petitioner,

vs.

Docket No. I-3806

WISCONSIN DEPARTMENT OF REVENUE,

Respondent.

* *

CERTIFICATION

KAREN A. CHERRY
MINDLA COMINS
LORETTA PETERS,

hereby certify that as the duly appointed reporters, we took in shorthand the testimony and proceedings had in the foregoing matter on the 7th day of October, 1974, and that the attached is a true and correct transcription of said shorthand notes and of the whole thereof.

Dated this 7th day of October, 1974.

Karen A. Cherry

Karen A. Cherry

Mindla Comins

Mindla Comins

Loretta Peters

Loretta Peters

STATE OF WISCONSIN

WISCONSIN TAX
APPEALS COMMISSION

* *

EXXON CORPORATION, (f/k/a Humble
Oil and Refining Company),

Petitioner,

vs. Docket No. I-3806

WISCONSIN DEPARTMENT OF REVENUE,

Respondent.

* *

TRANSCRIPT OF PROCEEDINGS in the above-entitled matter held before the Wisconsin Tax Appeals Commission, in Room 229, City-County Building, Madison, Wisconsin, on the 8th day of October, 1974, commencing at 9:30 in the forenoon.

PRESIDING: R. J. SMRZ, Chairman
THOMAS R. TIMKEN, Member
JOHN P. MORRIS, Member

ALSO PRESENT: JAY C. GITCHELL, Hearing Examiner

A P P E A R A N C E S

BOARDMAN, SUHR, CURRY & FIELD, Attorneys at Law, 131 West Wilson Street, Madison, Wisconsin, by THOMAS G. RAGATZ,

and

McBRIDE, BAKER, WIENKE & SCHLOSSER, Attorneys at Law, 110 North Wacker Drive, Chicago, Illinois, by LLOYD M. McBRIDE and PAUL D. FRENZ,

and

ROBERT E. TANNEHILL, Tax Attorney, Exxon Company, Houston, Texas, appearing on behalf of Petitioner.

IRVING F. SHAPIRO and ROBERT M. FINLEY, Tax Counsel, Wisconsin Department of Revenue, 201 East Washington Avenue, Madison, Wisconsin, appearing on behalf of Respondent.

MR. TIMKEN: Back on the record.

You are sworn, sir?

THE WITNESS: Yes, sir.

MR. TIMKEN: You may continue, Mr. Ragatz.

ROBERT D. KOONCE,

recalled as a witness, having been previously sworn under oath, testified as follows:

DIRECT EXAMINATION

BY MR. RAGATZ:

Q Mr. Koonce, before we recessed yesterday afternoon we had been discussing Exhibit 28. And I would ask you now to explain the alternative approach shown on Schedule A of that exhibit relating to the treatment of Exploration and Production as a separate business or as allocated to situs?

A Okay. The last set of figures on Exhibit A to the far right-hand side sets forth the taxable income and the tax that would be generated if Exploration and Production were treated as a separate business or it was allocated to situs under the statute. And in view of the fact that the exploration and production function is treated as a separate business, none of which is conducted within and without the

State of Wisconsin, it follows that it should be allocable to situs.

Q Is that the rationale for that alternative?

A That's correct.

Q And would you explain the rationale for the treatment of the income as situs income?

A The rationale for treating of the income as allocable to situs is that the production of oil and gas as related in the audit report is in the nature of income from mining and, therefore, should be allocated to situs.

Q Now did the net income of the E and P function as recorded on the company's books reflect the income derived from the production of oil and gas by Humble during the years in issue?

A Yes, it did.

Q Now I believe you have already indicated that the Department of Revenue respected the integrity of this figure by using it in its calculation?

A That's correct.

Q Now based upon your knowledge of Humble and its records can you state whether the E and P net income was in any sense created even in part by business within the borders of the State of Wisconsin?

A It was not.

MR. SHAPIRO: That calls for a conclusion. I object.

MR. TIMKEN: Will you read the question.

(Question read)

MR. TIMKEN: Mr. Ragatz?

MR. RAGATZ: Well, the question is intended to be a factual question based upon this man's intimate knowledge of the accounting record of the company and his background with the company. And, granted, it's hard to unscramble totally opinion from fact if the answer I am soliciting is intended to be a factual answer.

MR. SHAPIRO: Gentlemen, I would like to submit, if I may?

MR. TIMKEN: You sure may.

MR. SHAPIRO: That one of the principal issues in the case is whether the E and P Department is part of the unitary business along with the other parts of the company and whether any income generated by the

E and P Department is attributable to business done in Wisconsin. That's a fundamental issue.

MR. TIMKEN: Now, Mr. Shapiro, it seems to me that the ground we are covering here has already been covered. I think we will allow the witness to answer the question. I don't think it is the first time we have had this information, so we will overrule your objection and allow the witness to answer. And your objection is noted for the record.

MR. RAGATZ: I believe the answer is already on the record.

BY MR. RAGATZ:

Q Mr. Koonce, also based upon your knowledge of Humble and its records can you state as a matter of fact whether the income of the E and P function was fully earned at the point where the oil and gas was available for disposition?

MR. SHAPIRO: Same objection.

MR. TIMKEN: Same ruling.

THE WITNESS: It was.

BY MR. RAGATZ:

Q And also whether the refining and marketing functions served to increase or decrease the amount of the production income of the E and P Department?

A It did not.

Q Now turning back to Exhibit 28 could you explain why you made the calculation shown on Schedule C; and, again, because we used '67 as a model before, let's look at Schedule C for 1967.

A The reason that I made this calculation was, again, an alternative approach to demonstrate the substantial difference between the audit assessment and this approach and to demonstrate the overreach of the State's hybrid apportionment formula calculation.

Q Now would you explain the schedules and material shown on Schedule C?

A Well, on Schedule C on Page 1 of Schedule C for 1967 we have set forth the federal taxable income by function and made all of those adjustments that were made in the audit report and converted the federal taxable income by function back to a Wisconsin basis and then taking those other deductions that are provided by law.

And then over on Page 2 it sets forth the

net allocable income, the income which follows the residence of the taxpayer and the income which follows the situs of the property. And the next calculation of that allocable income is brought back over on Page 1 and deducted from the total income and that net allocable income includes the total income of the Exploration and Production Department, the Coal and Shale Oil Department, the Minerals Department and the Land Management Department as well as those other items that are allocable either to the residence of the taxpayer or to the situs of the property under the law.

And then those were deducted on Page 1 from total net income on a Wisconsin basis to get to apportionable income.

And then on Page 3 the factor was calculated using those factor attributes attributable to the apportionable income; and then the tax was -- Added back was the Wisconsin allocable income as determined from the audit report. And then the results of this year along with the other three years are summarized over on Schedule A.

Q Now would you explain the result of that calculation as shown on Schedule A?

A Well, the result of that calculation produces a taxable income of approximately two million dollars as compared to the State's audit method which produced four and a half million dollars. And this demonstrates, again, the overreach due to the interrelation of all of those adjustments that were made in the State's calculation, an overreach of about [illegible] million dollars.

Q Can you describe the difference between the results of this approach and the results of the separate accounting?

A Our separate accounting return for the four years indicated a net loss of 3.9 million dollars. This approach produced approximately two million dollars of taxable income; so there is a net increase even under this approach of about 5.9 million dollars between our returns as filed and this alternative.

Q Now does Humble agree with this approach?

A Well, it's an alternative but, again, we think that our separate accounting returns more properly reflect our operations in the State of Wisconsin.

Q How about the treatment of E and P income as income to situs under the statute? Does Humble agree with that approach?

A Definitel .

Q But that would go along the separate accounting approach; it would be implicit in the separate accounting approach, I believe?

A That's correct.

Q Now looking at Schedule A, the set of figures where only refining and marketing were apportioned as compared to the exclusion of the exploration and production net income, would you explain why there is a difference between those two calculations?

A Well, here again you get involved in an interplay of the income derived from each business as compared to its contributions to the factor attributes as provided under law, and that interplay of factor attributes in relation to the income of each one of these businesses changes this result somewhat.

Q It is really only a small change, isn't it?

A Yes, it is.

Q Now you have already testified that Humble uses posted field prices as to crude oil for purposes of accounting for the E and P function operations. What value does Humble use in accounting for gas operations of the E and P function?

A We use the sales price to third parties.

Q Is this the so-called field price that Mr. Carter described?

A That is part of it. The field price applies to that income which -- or that which is applicable to internal transfer.

Q And the rest of the gas went at third-party contract prices?

A That's correct.

Q For the internal transfers of gas, was the field price determined in arriving at E and P net income in the manner described by Mr. Carter?

A It was.

Q Is this field price of gas a well head price?

A Yes, it is, in most instances.

Q And where the field price is not at well head price, how do you obtain a well head price?

A Well, if the field price is not the well head price, if the field price applies to a transfer, internal

transfer, after it has been processed through a plant, gas plant, then you use what is commonly referred to in the industry as a Fiske formula to work that price back to what the value is at the well head.

Q Why do you need to obtain a well head value?

A You have to determine the well head value both for oil and for gas, for purposes of computing depletion, for purposes of paying severance taxes to the various states, and for purposes of settling with royalty owners and for purposes of settling with other interest owners.

Q Now as to crude oil, is the posted field price a well head price?

A That's correct.

Q And that can be used directly for those purposes you have just enumerated?

A That's correct.

Q As to gas, where the field price is not a well head price, you have to make this Fiske formula calculation?

A That's right.

Q Now would you describe the acceptance of the income derived by the E and P function for depletion purposes?

A Would you read that back?

(Question read)

A The prices that we were just talking about, the posted field prices and the well head prices, are readily acceptable for depletion purposes.

Q How about for severance tax purposes?

A The same is true for severance.

Q And for royalty purposes?

A The same is true for royalty purposes.

Q And for the purpose of valuing working interest?

A That's correct.

Q On the Wisconsin audit was any review made of the calculation and determination of these various expenses for categories you just discussed?

A Well, I really can't say other than to know that our books and records were available to the auditor and he reviewed our financial statements and our federal returns, and these deductions are set forth in the -- especially the depletion and severance taxes are set forth in those records.

Q And these were not challenged?

A Not to my knowledge.

MR. RAGATZ: At this time I would like to move the admission of Exhibit 28.

MR. SHAPIRO: We must object to the irrelevancy of Exhibit 28, particularly with reference to the computations included therein that have for their import the divided or functional accounting that the company uses as distinguished from the method that is used by the Department for Wisconsin income and franchise tax purposes of considering the entire company on an apportionment basis.

MR. RAGATZ: If I might be heard, I would like to say that counsel has now summarized the key issue in the case, and for petitioner to be denied the admission and consideration of this exhibit would deny the Commission an opportunity to examine the petitioner's arguments as expressed in the accounting numbers on the various points raised in this petition.

The matters set forth in these exhibits are summaries: we have laid a proper foundation of the business records rule for the admission of these summaries,

and we submit that the alternatives here are quite descriptive and should be quite helpful in the Commission's examination of the constitutional and statutory issues, and the issue of the proper application by the Department of its apportionment formula.

So we submit this exhibit is highly relevant to the consideration and determination of the issues in this case.

MR. TIMKEN: Before the Commission makes a ruling, I would like to ask Mr. Koonce a question regarding this exhibit.

THE WITNESS: Yes.

MR. TIMKEN: As you have explained each of these alternatives you have mentioned that when Mr. Ragatz asked you the question, "Does Humble accept them," you mentioned they were alternatives, but that Humble prefers the separate accounting basis they reported under, correct?

THE WITNESS: That's correct.

MR. TIMKEN: My question to you is: are they acceptable alternatives to Humble?

THE WITNESS: They are alternatives which are used in various areas of state taxation.

MR. RAGATZ: If the Commission would, please, when we get to briefing this case, I think we can set forth in the brief authority or lack of authority on certain of these positions, and probably get the alternatives in a better legal context than we can do by just putting it into evidence.

MR. TIMKEN: Very well. Now we will take a few minutes, gentlemen.

(Recess)

MR. TIMKEN: Back on the record. As far as Exhibit 28 is concerned, it is the ruling of this Commission that Exhibit 28 will be received subject to objection.

The State will have the opportunity to cross-examination regarding it. It will be helpful in the future for our deliberations so we are accepting it for what it is worth.

You may proceed, Mr. Ragatz.

(Exhibit 30 marked for identification)

BY MR. RAGATZ:

Q Mr. Koonce, can you tell the Commission where Humble obtained the crude oil that was exchanged with Pure at Lemont, Illinois during the years in issue under the foreign ticket exchange agreement mentioned by Mr. Campbell and Mr. Carter?

A They purchased it from three different purchasers and delivered it to the Lemont refinery.

Q Let me correct my statement. I meant to state Mr. Jeager, not Mr. Carter.

Now, would you repeat your answer for me?

A They purchased it from three separate sellers and delivered it at Lemont.

Q So this was not Humble-produced crude?

A No, it was not.

Q I just handed you a document that has been marked Exhibit 30. Would you identify what this is, please?

A Well, this is an exhibit which compares each function's contribution to the statutory apportionment formula, endorses its contribution of the net income adjusted to the Wisconsin basis.

Q Did you prepare this?

A Yes, I did, or under my supervision.

Q Now, would you explain what the term "factor attribute" means in this context?

A Factor attribute means these three factors that are provided for in the statute, the sales factor and a cost of manufacturing factor and a property factor.

Q Would you describe further what you have done on the various pages of this exhibit?

A The first page is a summary of the results of the next four pages which is calculations by years, each function's contribution to the factor attributes as compared to each of these business's contributions to the income.

Q Now, was this prepared from the same books and records that you described yesterday?

A Yes, it was.

Q And these books and records are here in the courtroom today?

A Yes, they are.

Q Will you describe what the comparison shows as to the results of the use of the apportionment method?

A On the summary page on the first page down at the bottom where it says "summary" it indicates that the Exploration and Production Department contributed 22.6 per cent of the factor attributes for this four-year period and they contributed on the average of 74.4 per cent of the income on a Wisconsin basis.

The marketing function contributed 22.3 per cent of the factor attributes and contributed 14.3 per cent of the income, and the Refining Department contributed 51.7 per cent of the factor attributes and 7.7 per cent of the net income, and the other functions contributed 3.4 per cent of the factor attributes and 3.6 per cent of the income.

Q Now, the column entitled "Per Cent of Income" represents the relative contributions of the various functional departments to the company's overall net

income, if I understand it correctly?

A That is converted on a Wisconsin basis.

Q And the per cent of factor attributes column, represents the attribution of that income under the factor attributes calculations to the statutory formula?

A It represents each of these function's contributions of the total factor attributes that are provided under the law.

Q Can you explain the rather significant differences, say, between the factor attributes for Exploration and Production at 22.6 per cent and its respective per cent of income at 74.4 per cent?

A Well, this whole exhibit was prepared to demonstrate that between the various businesses that are conducted by Humble there is not a correlation, direct correlation between contribution to the factor attributes and the contribution to income.

Q Does it demonstrate then a distortion?

A It demonstrates that, for example, if we are on a full apportionment method and you had a 1 per cent factor attribute, in the State of Wisconsin for every dollar of income that that 1 per cent factor draws into the State of Wisconsin it would be drawing 74.4 per cent in Exploration and Production income,

14.3 per cent of the Marketing income, 7.7 per cent of the Refining income, and 3.6 per cent of the other functions' income.

MR. RAGATZ: I would like to offer this exhibit at this time.

MR.SHAPIRO: Same objection on the same grounds.

MR. TIMKEN: The same ruling. Exhibit 30 will be received subject to objection for what it is worth.

BY MR. RAGATZ:

Q In conducting its audit and making its assessment, how did the Wisconsin Department of Revenue alter the statutory apportionment formula as it applied it to Humble?

A Well, they altered the statutory apportionment formula by weighting the cost of goods sold factor, cost of manufacturing factor.

Q Would you explain that?

A They tried to determine what per cent of Humble's total apportionment sales were sales of manufactured products, and that per cent they used to weight the denominator of the cost of manufacturing factor, and this produced a weight of about 60 per cent times

that 100 per cent contribution of the denominator of the cost of manufacturing factor, and that gave a weight of about six-tenths of one per cent to the denominator.

Q Then instead of the statutory denominator of three, what denominator figure was used?

A Around 2.6 or less.

Q Explain the three factors that were actually used in making this calculation.

A Well, they used a sales factor and made certain adjustments to that sales factor based on what they considered a nonapportionable income. They used this weight for the cost of manufacturing factor and in no way did they ever associate the cost of manufacturing factor with the actual cost of manufacturing in any way.

Q Explain what figures they used to arrive at this cost -- so-called cost of manufacturing for purposes of weighting?

A They used sales of manufactured products. To get to this weight they used the cost of manufacturing factor.

Q Is it or is it not a fair statement that then in effect two sales factors were used?

A You could describe it as that.

MR. SHAPIRO: Several questions are calling for conclusions.

MR. TIMKEN: Objection sustained.

Q Are there any official prescribed and published rules and regulations explaining the weighting procedure that you just described?

A No, there are not, to my knowledge.

(Exhibit 31 marked for identification)

Q I show you what has been marked Exhibit 31 and ask you to identify that document.

A This is a summary of the Wisconsin hybrid apportionment approach which I prepared.

Q And for what purpose was it prepared?

A It was prepared to try to explain to counsel the innerrelationships and to put into some kind of logical sequence the various alternative calculations that are made all through this audit report.

Q Would you point out on this exhibit where the statutory three-factor formula is changed into what we call hybrid?

A That is done over under Roman numeral VII.

Q And would you explain that a little bit? I don't mean through procedural steps; I mean just point

out what is done there.

A They have taken the total apportionable sales as calculated by the auditor and subtracted these items which represent sales of goods that were not manufactured by Humble, and then they get a ratio of the remainder to the total net apportionable sales, and that is what they used as the weight for the denominator of the cost of manufacturing factor.

Q And that is the procedure that you just previously described?

A That's correct.

Q Now would you point out and explain the so-called barrel formula portion of this overall calculation?

A Well, the barrel formula approach is set forth in Roman Numeral I.

Q What's the purpose of this so-called barrel formula? portion of the calculation?

A I will tell you what I think is the income that results. They attempted to trace Humble's production of crude oil and condensate, Humble's net working interest in crude oil and condensate. They tried to trace that, I guess, theoretically through the accounting records and attempt to try to determine what part of that crude oil and condensate that was produced was sold prior to entering the refinery. and what part of that crude oil entered Humble's refinery and was converted to other products which were subsequently sold.

Q Now in the process of the overall calculation what does the State's formula assume as to the net income provided by each dollar of sales of the E and P Department?

A Could you read that back?

(Question read)

THE WITNESS: The audit report assumes that each dollar of crude oil and condensate sales produces the same percent of net income.

Q What does the State's application of the formula assume as to the dollar return for each dollar of investment?

A The State's formula assumes that an equivalent dollar of investment attributes is required to produce the same amount of a percent of net income.

Q Based upon your familiarity with Humble's operations and its accounting records, are either of these assumptions factually valid?

A No, they are not.

Q Would you explain just briefly the variation in net income on various types of sales by Humble?

A Well, the net income on each sale of crude oil varies from lease to lease depending on the expenses and et cetera incurred applicable to the operation of that lease. And some of them are substantially different than others.

Q Do any such sales produce losses?

A I am sure they do.

Q How does the regulation of gas prices by the FPC affect the uniformity return on certain sales dollars?

A Well, the gas that is sold in interstate commerce is regulated by the Federal Power Commission, and the Federal Power Commission establishes area rate for gas sales prices, and intrastate sales of gas are not subject to that same regulation. So, therefore, the sales price could be substantially different between those two.

Q Would you explain the differences in return per dollar investment as to various activities of Humble?

A Well, this is looked upon, for example, on the drilling of an on-shore well as opposed to the drilling of an off-shore well where the costs are substantially greater than the drilling of an on-shore well, and the investment on an off-shore well is considerably greater than the investment in the on-shore well. There are all kinds of variations that you can get by leasing by well.

Q Now can you point out in this exhibit some places where in the mechanics of the calculation the State has multiplied a ratio by ratio? In fact, would you take and indicate on the exhibit in red those places where that kind of a calculation occurs, or at least some of them; and indicate, when you are marking it for the record, where you are making the mark.

Under I in the barrel formula, item 2-G is a ratio on a ratio. The net effect of 2-H is also the reciprocal ratio of that G calculation.

Would you make a mark right on each place on the exhibit or maybe draw a line under the ratio times the ratio calculation.

In the weight of the cost of manufacturing factor they use a ratio of sales manufactured to these total apportionable sales times the hundred percent weight of the denominator of the cost of manufacturing factor that's provided under the law; and that ratio on a ratio is produced in effect at Item VII-3.

(Answer continued)

A Also in adjusting the property factor for the non-apportionable percentage of the Exploration and Production Department income as determined under the audit, under Roman numeral VIII.

Q Now without taking too much time at this, maybe you could point out one more at this time.

A I don't see one offhand.

Q All right. I won't press you on it to find any more. Would you explain if you can what results you get when one ratio is multiplied by another ratio?

A You get a ratio that makes a whole lot of underlying assumptions and produces an estimate.

Q And if you know, of if you can describe it, what impact does this have on the overall formula calculation?

A Well, all through this calculation in the audit report the calculations and assumptions, et cetera, that are made are so interrelated and so forth, and so many underlying assumptions are made in the calculation of these ratios, and when you multiply those times other things to produce estimates and use that estimate to adjust something else, all you come out with is an estimate, which can -- may or may not have any relationship to the facts, and it substantially

in my opinion, distorts the results.

MR. RAGATZ: I would like to offer this exhibit at this time.

MR. TIMKEN: Mr. Shapiro.

MR. SHAPIRO: We have no objection to the exhibit insofar as it reflects what procedures were followed in the respondent's audit, but there are errors which we will find out on cross examination which we must except from our approval of the exhibit, so that with the exception of the errors which we will point out, we have no objection to the exhibit.

MR. TIMKEN: Mr. Ragatz, would you establish for the record who actually prepared this exhibit.

MR. RAGATZ: He testified he prepared it, I believe.

MR. TIMKEN: Is that correct?

THE WITNESS: That's correct.

MR. TIMKEN: Very well; Exhibit 31 is received and the respondent will be given the opportunity, of course, to explore it on cross examination.

BY MR. RAGATZ:

Q During the testimony of Mr. Carter he pointed out that only approximately 4 percent of the natural gas produced by Humble was transferred to its Refining Department and that the gas transferred was all consumed as fuel and resulted in no products. From the Wisconsin Department's formula have you been able to determine what portion of the natural gas produced by Humble was actually included in apportionable income in the calculation?

A It is approximately 10 percent of something.

Q Ten percent is your answer?

A That's correct.

Q Approximately two and a half times the 4 percent that Mr. Carter indicated actually went in?

A That's correct.

Q What factor or assumption, if you know, contributed the most to this difference?

A The factor that contributed the most to this difference was the treatment of gas plant gas income as being apportionable.

Q As I understand the State's theory, it would be that where gas or oil is converted to another product, it loses its allocation to situs under the income ~~for~~ from

mining portion of the statute. Is that your understanding of the decision?

A I think that is correct.

Q Now then, to the best of your understanding, is the State being consistent with its theory when it includes gas plant gas sales ~~and~~ in apportionable income.

MR. SHAPIRO: Objection.

MR. RAGATZ: I might explain I have laid a proper factual background, both with this witness and the prior witnesses for this witness to state his understanding as to whether the State is being consistent in its application of the theory applied to the facts.

MR. TIMKEN: Would you read that question.

(Question read)

MR. TIMKEN: We will allow the witness to answer that question.

A Based on my understanding of the State's approach, for example in the area of crude oil where theoretically some of the Humble-produced crude, under their formula,

gets transferred to the refinery and it is changed into other products and there is an internal transfer and then subsequently sold on down the line, theoretically with respect to gas -- the gas plant gas income -- they are not being consistent and not being -- well, in that natural gas is produced, it goes to the gas plants, and then it is sold at the tailgate of the gas plants, and this is natural gas when it is produced and it is natural gas when it is sold at the tailgate of the plant, and the only thing that has happened to it is it has had some of the liquids extracted that is in the gas in the plant.

MR. TIMKEN: We will take ten minutes.

(Recess)

MR. TIMKEN: Back on the record. Mr. Ragatz?

MR. RAGATZ: I have no further questions of this witness.

MR. TIMKEN: Mr. Shapiro, you may cross examine this witness.

MR. SHAPIRO: Thank you.

CROSS EXAMINATION

BY MR. SHAPIRO:

Q Mr. Koonce, where is the location of your office?

A It is in Houston, Texas.

Q Is that in the Headquarters Building that Mr. Luper described?

A That's correct.

Q To whom are you responsible?

A To whom am I responsible?

Q Yes.

A To the manager of the Tax Department.

Q And the Tax Department -- do you have before you Exhibit 20?

A No, sir, I sure don't.

Q I might just ask, the Tax Department is part of the corporate staff, is it not?

A That's correct.

Q I would like to refer you to Exhibit 28, Schedule D, Page 2.
A All right, sir.
Q You compute that Wisconsin apportionment fraction by using -- let me strike that question.
I would like to ask another question first. Does the Marketing Department perform any manufacturing?
A Not to my knowledge.
Q Is your answer no?
A No.
Q On this Page 2 you compute the Wisconsin apportionment fraction by using the cost of manufacturing as zero in Wisconsin and dividing the sum of the three percentages of property, cost of manufacturing and sales by three, is that correct?
A That's correct. The reason I did that --
Q I will ask you about that. If there is no manufacturing why did you not divide by two rather than three?
A The reason that I did that is that the statute provides for dividing by three, and I did not have any alternative to divide by two. Only the Department of Revenue has that prerogative.
Q Are you also aware that the statute provides for the elimination of a factor?

A On the part of the Department of Revenue.

Q Or ~~in~~ on application?

A Only on the part of the Department of Revenue.

Q Next I would like to refer you to Schedule B and that relates to each year on this exhibit. Let's turn first to Schedule B for 1965.

Each column on that page, each column of figures is a functional financial report or statement for that department, isn't that true?

A That's correct.

Q Now, if we would add up the individual gross receipts figures on Line number 1 for each department across the line, we would have a pyramiding of sales, isn't that right?

A If you add up all of these sales across column 1, after the elimination of --

Q I didn't ask you that.

A Well, across these columns, the total ties back to the company's total.

Q You are not answering my question. If we add up the totals of each department, E and P, Marketing and Refining and so on, if we add them up, before we get -- I am referring only to the department columns.

A Administrative is a department.

Q It would result in a pyramiding of sales, wouldn't it?

MR. RAGATZ: I'm going to object to that question unless he defines "pyramiding" and unless the witness understands what pyramiding means.

MR. TIMKEN: Does the witness understand what pyramiding means?

THE WITNESS: Well, I don't understand specifically what his question is.

MR. TIMKEN: Would you rephrase the question, Mr. Shapiro?

THE WITNESS: The totals across all of the top columns on Line 1, the totals by department total back to the company's totals.

BY MR. SHAPIRO:

Q Yes, sir. But if we stop -- I call your attention to the column entitled "Enjay." That is the last column, isn't that correct?

A That is the last functional operating department, that's correct.

Q Now, if we stop there and if we were to add all the figures on Line number 1 for gross receipts, that

total figure would result in a pyramiding of sales?

MR. RAGATZ: Same objection.

Q And an overstatement of sales, would it not?

MR. RAGATZ: If you understand.

MR. TIMKEN: Do you understand the question? If you don't, say so.

THE WITNESS: I understand the question.

MR. TIMKEN: Can you answer the question?

THE WITNESS: Yes, sir.

MR. TIMKEN: Would you answer it, please?

THE WITNESS: It does not overstate each department's sales.

BY MR. SHAPIRO:

Q That does not answer the question, sir.

A You said --

Q Would it result in an overstatement of total sales, if we stop at the point that I indicated?

A It represents the sales of each department before elimination, if that is what you are driving at.

Q The E and P Department's transfers to refining are set up as the Refining Department's cost of sales, isn't that true?

A That's correct.

Q And the Refining Department's transfers to marketing

are set up as the Marketing Department's cost of sales?

A That's correct.

Q It is necessary to eliminate certain intracompany transfers because a transfer from one department to another department is not a sale to an outsider, isn't that true?

A That's correct.

Q Now, these eliminations are made in the column entitled "Administrative," correct?

A That's correct.

Q For the year 1965 these eliminations are in the amount of two billion two hundred and seventy-four million fifty-nine thousand eight hundred eighty-seven dollars?

A That's correct.

Q And noting for the year 1967 in Schedule B, these same eliminations are two billion five hundred seventy-three million -- round it off at that point, isn't that correct?

A That's correct.

Q And for 1968 we have similar -- I skipped 1966; I'm sorry.

For 1966 it is two billion three hundred sixty-three million, and 1968 is two billion six hundred

ninety-one million, isn't that correct?

A I think that's right.

Q Do you follow?

A I didn't catch your first number for 1966.

Q Okay. 1966, Schedule B, the elimination is two billion three hundred sixty-three million?

A That is correct.

Q Going back to 1965, similar eliminations are made for the cost of goods sold on Line number 2 for each year?

A That's correct.

Q And the same is true with respect to Line number 3, is that right?

A The elimination that is in Line 3 represents an adjustment to inventory.

Q Well, let's consider then the principal eliminations in the billions of dollars referred to for gross receipts and cost of goods sold only. After these eliminations we arrived at a total company figure, did we not?

A That's correct.

Q Why are these eliminations made?

A They are made only for purposes of the preparation of the Federal Tax Return and also for the preparation

of the company's total income and expense table.

Q So that for these purposes, the total figures on the right are the significant figures?

A The far right?

Q Yes, sir.

A The total column?

Q Yes.

A For the total company, that's correct.

Q Now, Mr. Koonce, on direct examination yesterday you testified that Pate Oil Company reported its Wisconsin operations beginning in 1956, isn't that right?

A That's my understanding.

Q Now, did Pate do any of its business outside of Wisconsin?

A Not to my knowledge .

Q So they reported all of their income to Wisconsin therefore ~~that-fall~~, isn't that correct?

A That's correct.

Q I believe you testified that they reported on a separate accounting basis?

A That's correct.

Q Now if Pate was not a multi-state corporation, and you concede to that, and reported all of its income to Wisconsin, will you explain why you refer to that reporting as a separate accounting reporting?

A Well, it was a separate accounting for Pate's operations within the State of Wisconsin as reflected by their books and records.

Q Separate from what?

A Separate from outside the State of Wisconsin.

Q Did they do any business outside the State of Wisconsin?

A No, they did not.

Q Then why do you have to separate?

A Well, it just reflects the summary of their accounting results within the State of Wisconsin on this separate basis conducted within the State of Wisconsin.

Q How do you know this, Mr. Koonce?

A I have seen the Pate return.

Q You have seen the Pate returns?

A Yes, sir.

Q Based on your knowledge of the Pate returns is it a

correct statement that for the four years just prior to Humble coming into Wisconsin Pate reported very substantial amounts of Wisconsin taxable income?

A I don't know what those numbers were off the top of my head.

Q But you have seen the returns?

A They did have some taxable income.

Q You don't know the amounts of net income reported?

A I don't remember off the top of my head.

Q Do you remember approximations?

A I wouldn't with any given year.

Q But based on your knowledge Pate was a profitable operation, was it not?

A Well, from the returns I saw they had taxable income. I don't know if that makes them profitable or not.

Q Now during the audit years Humble earned a higher rate of return from its investment in E and P than it did in Refining and Marketing, is that true?

MR. RAGATZ: Objection. What relevance has that got to the issues in this case? That sounds like anti-trust.

MR. TIMKEN: Mr. Shapiro?

MR. SHAPIRO: I will move on to another question.

MR. TIMKEN: Are you withdrawing that question?

MR. SHAPIRO: Yes, sir.

BY MR. SHAPIRO:

Q Mr. Koonce, you have testified that you didn't like the State's average return on investment formulation because the returns vary from one aspect or segment of the business to another. Now tell us for the period in question what the return on investment was for E and P?

MR. RAGATZ: Same objection.

MR. TIMKEN: It sounds like anti-trust; would you explain that for us?

MR. RAGATZ: First of all, Mr. Shapiro is characterizing in his question something that I don't believe the witness testified to. I think the witness testified that different activities such as off-shore operations as opposed to on-land operations earn different returns; but he didn't characterize it by function.

MR. TIMKEN: Mr. Shapiro?

MR. SHAPIRO: He testified as a differentiation. He testified as to

different rates of return being proper or different segments of the business.

MR. RAGATZ: No, he did not. He testified only that the State's assumption that a uniform rate of return was factually incorrect. He did not testify what the rates of return are; and I don't think he could testify what they are.

MR. TIMKEN: Are you objecting on a relevance basis then, Mr. Ragatz?

MR. RAGATZ: Yes. I don't believe that this is relevant. First of all, it was not covered by the direct examination. But I don't believe it's relevant and I am not at all sure that this witness could answer it even if the Commission deems it relevant.

MR. TIMKEN: Well, as both parties know, since the inception of this hearing we have been giving the parties wide latitude as far as relevance is concerned. It's our belief that we should get as complete a record as possible; and at times the relevance might seem dubious to

the other party.

We have allowed the petitioner to explore that because we are not a court of record and we have that function. And we think we should allow as complete a record as possible. We have allowed the petitioner that and we intend to allow the respondent leeway in relevance until it becomes patently irrelevant to us.

MR. RAGATZ: I would like to make a further statement if I might.

MR. TIMKEN: Yes.

MR. RAGATZ: I made this statement on the record on Friday when we were arguing another objection; but I am concerned and do not intend to sit quietly as to questions that bear basically on anti-trust ramifications and not on the tax ramifications. This is not an anti-trust matter in any degree. This Commission has tax jurisdiction and no other jurisdiction; and we are not about to see our client subjected to anti-trust inquiry that might or might not be useful in some other

proceeding. And so then I will be ~~re-~~ pro- ~~questing~~ testing and objecting, if necessary, to any inquiry that I deem to be beyond the scope of this Commission's jurisdiction or the scope of this proceeding.

And, as I indicated on Friday, that, if necessary, I would instruct the witness not to answer such an inquiry or, if he is required to answer it, consider taking an interlocutory appeal on it. We feel very strongly that anti-trust has no place in this proceeding and, when Mr. Shapiro starts talking about functional return on investment, I can only think that his inquiry is anti-trust-oriented and not tax.

MR. TIMKEN: That's why, Mr. Ragatz, I asked you whether your objection was relevance or anti-trust.

MR. RAGATZ: I am sorry. I had forgotten that you were not here when I made that argument on Friday.

MR. TIMKEN: That argument was reviewed with me so I was aware of it.

MR. SHAPIRO: I would like to respond.

MR. TIMKEN: Yes, you may.

MR. SHAPIRO: If a question may have some relevance to anti-trust, it also may have relevance to the issues involved herein. And because it may have an anti-trust relevance, we submit that having the question answered for our purposes here is entirely proper.

MR. TIMKEN: I would agree with Mr. Ragatz that we should not get into anti-trust matters.

MR. SHAPIRO: I agree.

MR. TIMKEN: At this point I don't see how that question bears in an anti-trust fashion; and I have opened argument on that respect. If you can show us the anti-trust relevance, we will stop the questioning along that line because I agree we shouldn't get into anti-trust matters. I don't see how this has any bearing on us, Mr. Ragatz.

MR. RAGATZ: It seems to me it puts the reverse burden on the petitioner.

It seems to me that the burden should be on the respondent to show that his position is relevant to the inquiry.. I don't know what question the return on investment of the E and P function -- why that should be relevant to the tax inquiry.

MR. SHAPIRO: He has testified regarding return on investment. We are developing that.

MR. TIMKEN: Now maybe we had better go back to the question. Would you read it to me, the one that's in issue here under discussion? Can you get that far back?

(Question read as follows: Mr. Koonce, you have testified that you didn't like the State's average return on investment formulation because the returns vary from one aspect or segment of the business to another. Now tell us for the period in question what the return on investment was for E and P?)

MR. TIMKEN: Mr. Ragatz, we are going to allow the witness to proceed. I assume you will be protecting your client's interest and, of course, in response to your comment about taking interlocutory appeal, you, of course, may do that if you don't agree with us. But by the other token, up here we have to make the rulings as we go along and the parties may not agree with them. But we are going to make them based on our own judgment.

We will now let the witness answer that question. Your objection is noted and if he gets into anti-trust, I will assure you we will stop it because we don't think he has a right to go into that. So the witness may answer if he can.

THE WITNESS: Would you read the question back again?

(Question read)

MR. RAGATZ: Yet another interjection

I would like to interpose and that is there is no foundation for this question which I have also indicated, but also there is no foundation as to what counsel means by "return on investment" or how counsel is asking this be calculated. And I think it will develop that this witness does not have that kind of information in the first place, so maybe we are all wasting our time.

MR. TIMKEN: Could you define what you mean, Mr. Shapiro?

MR. SHAPIRO: Well, the witness is an accountant and percentage return on investment I submit should be very familiar to him.

MR. TIMKEN: Can the witness answer this question; do you understand the question?

THE WITNESS: As to rate of return on the investment?

MR. TIMKEN: Can you answer it?

THE WITNESS: I don't have any figures here to answer that question.

MR. TIMKEN: Can you answer the question yes or no?

THE WITNESS: Yes, sir, I can answer yes or no.

MR. TIMKEN: And what is your answer?

THE WITNESS: No.

MR. TIMKEN: You are right. It was moot. He said, "No."

MR. SHAPIRO: He said, "No"?

MR. TIMKEN: He said,"No."

BY MR. SHAPIRO:

Q Isn't it true, Mr. Koonce, that the federal tax structure encourages Humble to take as much profit as possible in E and P?

MR. RAGATZ: Objection. Now that's asking for a conclusion that's unwarranted. If he wants to draw that conclusion in the brief, he can do that. But I don't think he needs to ask our witnesses whether the company distorts its figures.

The witness has testified as to the procedure used to arrive at the functional net profit and including the net profit of the E and P function all related to federal

income tax purposes. If counsel wants to draw conclusions, he can draw them in his brief.

MR. TIMKEN: Mr. Shapiro, you may be heard.

MR. SHAPIRO: The respondent is treating the company as a whole pursuant to its apportionment method. And it is apparent, of course, that the company seeks to exclude from the apportionment method the E and P function.

What the respondent is getting at are reasons and bases for loading profits into the E and P function, and thereby depriving, under their version of this case, Wisconsin of its legitimate share of the net income of the entire company.

MR. TIMKEN: Now may I have the question read back to me so I have it inproper context?

(Question read)

MR. TIMKEN: Do you want to say something, Mr. Ragatz?

MR. RAGATZ: Well, I would submit that if counsel would stipulate that Humble's E and P function does not belong in Wisconsin taxable income, then the source of this inquiry, as far as it goes to facts and not legal conclusions might be pertinent. But the Department has already used the E and P net income of this taxpayer in its own calculations; and it seems a little strange for it to be now challenging the determination of that E and P.

And I submit that the reason this inquiry is made and this whole line of questions is based upon the theory of the respondent's expert witness which is an anti-trust theory that profits are unreasonably raised at the E and P functional level. And if the Commission wants to let the respondent's expert witness testify to that, it will be over our objection. But I think we can reserve that until that occurs.

But as to this witness, I don't think

that's a proper question and, among other things, it's asking him to draw a legal conclusion which he is not qualified to draw.

MR. SHAPIRO: There have been innumerable conclusions called for by petitioner's counsel; and we submit they have been permitted -- the witness has been permitted to answer them.

MR. TIMKEN: Now, then, Mr. Ragatz, I agree with you that we will have to await to/if and when the Department's expert witness does attempt that procedure. We will sustain your objection on the matter before us at this moment.

BY MR. SHAPIRO:

Q Mr. Koonce, are any expenses or costs allocated to Wisconsin under your separate accounting method that relate to the investment account?

A That relate to the investment account?

Q That is, the cost of these funds.

MR. RAGATZ: I guess I don't want to keep interrupting, but there was nothing on direct examination that related to funds of the company, and there is no foundation for this cross examination question, plus I don't even understand the question.

MR. TIMKEN: Does the witness understand the question?

THE WITNESS: No, sir, I sure don't.

MR. TIMKEN: Would you rephrase the question?

MR. SHAPIRO: Sure.

MR. TIMKEN: I should inform the witness if you don't understand the question I wish you would say so it can be rephrased.

THE WITNESS: Okay.

MR. SHAPIRO: I withdraw that question. Could we take five minutes.

MR. TIMKEN: We will take ten minutes.

(Recess)

CROSS EXAMINATION

BY MR. SHAPIRO:

Q Mr. Koonce, would you please refer to Exhibit 31, Page 3.

A I don't have the exhibit.

Q You don't have it before you?

A Okay.

Q Roman numberal III-2 -- are you there? Income which follows commercial domicile?

A Yes, sir.

Q What is your understanding of the term "commercial domicile?"

A My understanding of "commerical domicile" is the location from which the operations of the business -- excuse me -- it is the location at which the taxpayer has its principal place of business.

Q And is that distinguishable from another type of domicile for a corporation?

A Yes, it is.

Q And what is the other type?

A The legal domicile.

Q And is it your understanding that Wisconsin -- the Wisconsin Franchise and Income Tax Law provides that dividends and interest income shall follow commercial domicile?

A That is my understanding. That is what the auditor indicated.

Q When did he indicate that?

A During the audit.

Q Which auditor?

A Mr. Sheridan.

Q Verbally?

A Yes. That certainly is not unusual.

Q What is not unusual?

A For dividends and interest to follow the taxpayer's commercial domicile, sir. It is done everywhere.

But that is your understanding as to Wisconsin law?

Yes, sir.

You stated that the profit per barrel of crude oil can vary considerably from lease to lease and the cost of producing oil from off-shore wells can be substantially higher than the cost of oil from on-shore wells, is that true?

That is correct.

Q Do your accounting records show the costs and net profits broken down for each well or lease?

A We have to determine net income from the property for depletion purposes, yes, sir.

Q Can you trace each barrel of oil from the well head to its ultimate destination either into your own refineries or to other third-party purchases of crude?

A I cannot.

Q If you were asked to determine a method as to how much net income was attributable to crude oil sold before entering your refineries, could you divise a method better than that used by the auditor?

A The net income from all -- would you repeat that?

(Question read)

A Yes, sir, I think I have done that in the Exhibit 28, and all of it is applicable to the -- that all of the income from the production of oil is set forth in my Exhibit 28 as Exploration and Production Department income and that income is the income attributable oil prior to entering the refinery.

Q Are you referring to your Schedule A of Exhibit 28 in the columns over to the right?

A Well, let's go back and look at any year where Exploration and Production income is set out, and that income is set out in here as Exploration and Production income, and it is the income prior to entering the refinery.

Q Where is that set out specifically?

A For example, on Schedule B --

Q Schedule B?

A Yes.

Q For what year is that?

A For, say, 1967.

Q Schedule B, 1967, okay. Where is the amount?

A Where is the amount?

Q What are you referring to on that page, sir?

A All of the income on here other than those miscellaneous items of income are applicable to the production of oil and gas and exploration and production activities, and all of that income is set forth within these columns.

Q But does computation for the amount of net income attributable to crude oil sold to outsiders before entering your refinery?

A No, it does not. Excuse me, would you read back?

(Question read)

A Yes, it does.
Q Where does it say that?
A It is in these figures. It doesn't show it separately.
Q You can't point to a figure that says exactly that, though?
A No, I can't, except that all of it is from oil and gas, most of it.
Q Could you give us a better method than that used by the auditor to determine that precise figure?
A To determine the --
Q The net income attributable to crude oil sold to outsiders before entering your refineries?
A There are probably several different methods that you can use to -- if you want to make a whole bunch of underlying assumptions --
Q At the moment do you know of any better method than that used by the auditor?

MR. RAGATZ: I am going to object to this question on the basis that it isn't incumbent upon petitioner to say the correct, or a correct method of calculation. The petitioner only has the burden of showing that the method used by the respondent was arbitrary and violating the

statutes. If counsel wants to ask our expert accounting witness, who will follow this witness, to develop such a method, I am sure our expert witness can do it. I don't think that is our responsibility, however.

MR. TIMKEN: Mr. Shapiro?

MR. SHAPIRO: I have no further questions.

MR. TIMKEN: You are withdrawing that question.

MR. SHAPIRO: No, no.

MR. TIMKEN: You have no further comments on that objection?

MR. SHAPIRO: That's right.

MR. TIMKEN: So you want it answered if the Commission overrules the objection, is that correct?

MR. SHAPIRO: Mr. Commissioner, I think the witness should answer that question. I submit that he should answer that question.

MR. TIMKEN: I agree he should if he can. This witness has testified at length on various methods, and I think the respondent is entitled to ask him that question, and if he can

answer it, he should; if he cannot, he should say he cannot. The objection is overruled.

A I think probably I could develop a better method, but not from the numbers that I have got here in this exhibit. I would have to go to other sources.

Q But you have no better method in mind now?

A I can't specifically tell you a method right now without going back and making an attack in that part of the formula, there is just a whole lot of underlying assumptions that maybe would not be relevant.

MR. SHAPIRO: I have no further questions.

MR. TIMKEN: Re-direct, Mr. Ragatz?

REDIRECT EXAMINATION

BY MR. RAGATZ:

Q Mr. Koonce, in reviewing the method used by Mr. Sheridan to arrive at income from the sale of crude oil at the well head, did he or did he not use posted field prices as the value determined for these sales?

A He did.

Q And in intra company accounting for the value of the crude transferred from the E and P function to the Refining function, did you or did you not use posted field prices as the value determined for the amount of crude oil transferred?

A That's correct, for both purposes; that is sold at the lease and that is transferred to the referinery, it is the same.

Q Then as far as sales to third parties are concerned, both your calculations internally for accounting purposes and Mr. Sheridan's calculations relied on the same basis?

(Last question read)

MR. SHAPIRO: That certainly is a leading question, Mr. Examiner.

MR. TIMKEN: I don't think so; overruled.

A We both used the same records, yes.

MR. RAGATZ: No further questions.

MR. TIMKEN: Any re-cross?

MR. SHAPIRO: No, sir.

MR. TIMKEN: Mr. Koonce, you are excused.

THE WITNESS: Thank you.

MR. TIMKEN: Mr. Ragatz, is your next witness going to be a lengthy one?

MR. RAGATZ: Yes.

MR. TIMKEN: Would you prefer that we waited until after lunch? It is a quarter to.

MR. RAGATZ: That's all right.

MR. TIMKEN: Mr. Shapiro, is that all right with you?

MR. SHAPIRO: Yes, sir.

MR. TIMKEN: Very well, we will adjourn until 1:30.

(Noon recess)

MR. TIMKEN: Gentlemen, are we ready to go?

MR. SHAPIRO: Yes, sir.

MR. TIMKEN: Mr. Ragatz, you may call your next witness.

MR. RAGATZ: The petitioner calls Ernest L. Wehner.

ERNEST L. WEHNER,

called as a witness, having been first duly sworn, under oath, testified as follows:

DIRECT EXAMINATION

BY MR. RAGATZ:

Q State your full name, please.

A Ernest L. Wehner.

Q Where do you live?

A In Houston, Texas.

Q How old are you?

A Fifty-four.

Q Would you describe your academic background?

A I graduated from high school in Del Rio, Texas, and attended the Texas A & M University and was graduated in 1941 with a B. S. Degree and Major in Accounting.

Q Did you earn any honors in undergraduate school?

A I graduated with honors from the Texas A & M University.

Q Have you taken any postgraduate work?

A Not specifically. I have been to several seminar -- graduate seminar courses and I have taken some graduate courses in preparation for the certified public accountant's examination, but I have very little graduate work.

Q Will you describe professional societies you belong to?

A I am a member of the American Society of Certified Public Accountants, the Texas Society and Houston Chapter of Certified Public Accountants.

Q Have you served in an officer's capacity in the societies?

A Yes, I am a member of the Board of Directors for a number of years, both at the state level and local level.

Q Have you written or participated in the publication of any books?

A Yes, I have.

Q I show you for the record a book entitled "Oil and Gas Federal Income Tax Manual, 9th Edition, 1966,"

and ask you about your participation in the preparation of that book.

A Yes, I was the Chief Editor of that book.

Q Is that a book put out by your firm?

A Yes, it is.

Q Have you participated in more than one edition of that book?

A I have participated in the editorial work on about the last six editions of the book.

Q And, I show you Exhibit 11-11 admitted into evidence in this proceeding and inside the front cover of that exhibit is a list of books that Mr. Kaspar referred to in connection with the audit he made of the Humble Oil and Refining Company.

Do you find your book on that list?

A Yes, it is at the head of the list.

MR. RAGATZ: Let the record show that the witness is referring to the first book listed on that, which bears the name of the book just described in evidence.

Q What is the circulation of that book, Mr. Wehner?

A That printing was 20,000 copies.

Q Are you a certified public accountant?

A Yes, I am.

Q How long have you been?

A I was certified in 1947.

Q Have you written any other books or papers or made any other presentations that you would like to note here?

A I have been a speaker at many major tax seminars throughout the country; seminars such as at the Tulane Tax Institute, the University of Wichita Tax Institute, the University of West Virginia and the University of Texas, quite a number of the major tax institutes.

Q Have you had any government service?

A I have not had any specific government service as an employee, but in 1967 and 1968 I was one of the three certified public accountant members of the adversary group to the Commissioner of Internal Revenue in Washington, and on several occasions I have served as a Special Consultant to the Treasury Department; once in connection with matters pertaining to oil and gas income tax regulations, and once in another extraneous ~~extenuous~~ tax matter.

Q Will you describe your employment history since graduation from college?

A I was inducted into military service for five years

immediately after I was graduated in 1941, and I started to work for Arthur Andersen & Company in its Houston office on May 1st, 1946, and I have been constantly employed in that office in Houston since that time.

Q What is your present position with your firm?

A I am the managing partner of the Houston office.

Q What positions with the firm have you held prior to this present position?

A Prior to the time that I was put in charge of the Houston office I had been, for many years, the head of the Tax Department, about the previous 10 years, and I also was in charge of all oil and gas taxation policy matters for the entire firm for a period of about 15 years preceding that.

Q Would you just briefly describe the nature of Arthur Andersen & Company?

A The firm of Arthur Andersen & Company is an international firm with about 100 offices in 34 countries in the world. It has about 13,500 employees and about 900 partners. It does a gross volume of business on the order of 300 million dollars.

Q Do you hold any positions in management of that international firm itself?

A I am a member of the Board of Directors of that firm.

Q How large is that Board?

A It has 12 elected members and three or four appointed members.

Q Would you describe the Houston office of Arthur Andersen & Company that you manage?

A Houston is the third largest office of the firm. It presently is composed of about 535 people, including 33 partners.

Q Would you further describe your experience in the oil and gas industry with firms other than Humble Oil and Refining Company?

A Starting with my first experiences in the Houston office of Arthur Andersen & Company in 1946, I was initially engaged in doing work in the Audit Division and got some experience in auditing, and I later decided to specialize in taxation, and from that point forward I would say that I spent a large majority of my time in various phases of the oil and gas industry; much of that time being spent in the taxation side, but also in general accounting and management information systems and other services.

Q Now, would you describe the experience that you had

with other multi-functional oil and gas corporations?

A Well, our firm in Houston are the auditors of a number of firms that were mentioned by Mr. Luper in this exhibit that he put on of the listing of some of the companies that had multi-functions, and others that have a limited number of functions, and we audit in Houston some of the largest and some of the smallest independents. We sort of cut across the entire scope of the activities of the oil and gas industry.

Q Would you also mention briefly any experience that you have had with other multi-state corporations besides oil and gas companies?

A We have had experience, and I have been very close to a number of companies in the manufacturing business that cross state lines and have manufacturers in sales in multi-state activities. We have others that have principally distribution-type operations that cross state lines and service-type industries that cross state lines also.

Q Going back to the oil and gas industry, would you describe some of the major companies with which you have experience, including the nature of their functional operations?

A I will give you the names of some of these companies, but I will not be able to discuss very much of the work that I do for them because of the confidentiality of it, but there is the Texaco, Incorporated, which is on Mr. Luper's list, Esso and Skelly Oil, which is on Mr. Luper's list, and I am also very familiar with such companies as Tenneco and Pennzoil and Superior Oil Company, and a number of the larger multi-functional companies.

Q Are these companies all operating in the three major functional areas of E and P, Refining and Marketing?

A Not all of them. For example, the Superior Oil Company is principally in exploration and production.

Q Have you had experience with other companies in the oil and gas industry that operate in less than all of the three major functions?

A Yes.

Q How long a period of time in total have you been involved in the oil and gas industry accounting capacity?

A About 28 years.

Q Would you describe your familiarity with the Exxon Company USA and its predecessor, the Humble Oil and Refining Company, prior to this case?

A Yes, I have had an affiliation of one kind or another with work for the Exxon Corporation dating back to about 1958 or '59; rather limited, but at that time I personally reviewed the federal income tax returns for the years 1958 and 1959 before they became a wholly-owned subsidiary of the Standard Oil Company of New Jersey, and I have consulted with them on various special projects from time to time and have reviewed certain information that I was preparing for technical papers and in the preparation of this book of which I was the editor and I have had quite a close contact with their Tax Department over the years.

Q And did this exposure to the operation of Humble Oil and Refining Company include exposure during the years 1965 through 1968?

A Yes, it did.

Q Can you think of any particular projects or assignments that you had in connection with this company that might be germane to the present subject at issue?

A In connection with my consulting with the Treasury Department in 1967 and 1968 I had several conferences with a number of the executive personnel of the

Exxon Corporation with respect to some of the procedures that they had used for years in connection with oil and gas taxation.

Q During this period was Arthur Andersen & Company the public accounting firm that audited Humble Oil and Refining Company or Standard Oil of New Jersey?
A No, sir.
Q What company was that?
A Price Waterhouse were the auditors.
Q Now drawing on your long experience in the oil and gas industry, would you please describe the utilization of posted field prices for accounting purposes?
A Yes. As has been mentioned by previous witnesses, the posted field price is an available figure which gives you a figure at which crude is bought and sold in the market place and in various areas. And so in accounting we use that as the measure of profitability and sales value for various products. And it's also used very extensively in oil and gas taxation for both state and federal income tax purposes.
Q Does this use include internal transfers of crude oil?
A Yes, it does.
Q Would you describe that to us?
A Well, when a company is in a multi-function situation and owns its own production and also has refineries, in order to properly account for the performance of the various functions, they use a posted field price

as the measure of value in transferring crude from the E and P Department into the refining function.

Q Now during the years in issue in this case was this a well-accepted and widely-used practice in the industry?

A Yes. Without exception I believe the oil companies used the posted field prices.

Q And that's for internal transfers as well as sales to ~~preferred~~ third parties?

A Yes.

Q Now what kind of a transfer price was used for natural gas?

A For natural gas. Ordinarily there are two ways that you can determine fair market value of natural gas and that is by relating it to contracts that are to be effective at the well head and others where there is a market only for the gas at the tailgate of a natural gasoline plant.

Q When you have gas with a price at the tailgate of the gas plant, how do you compute the well head price?

A We use a backup formula which has been referred to by the prior witnesses as the Fiske formula. And that formula in effect takes the value of the gas at the tailgate of the plant and through eliminations of

various items backs up the costs and values back to the well head.

Q How did this formula get its name?

A It was derived by a man who at that time was the Senior Review Engineer for the Internal Revenue Service in the Southwest Region at Dallas; and his name was Leland Fiske.

Q Did you personally know him?

A Yes, I did.

Q During the years in issue, was this Fiske formula or equivalent backup-calculation well accepted and widely used in the industry?

A Yes, because of Mr. Fiske's senior position in the Internal Revenue Service and because of its practicality, it was very widely accepted for both federal and the state income tax purposes.

Q Now would you describe the use of posted field prices as to crude oil and Fiske formula as to gas for depletion calculations?

A Yes. The depletion is allowed on the value of the product at the well head; and that value must be determined as a fair market value in dealing in an arm's-length basis where you are dealing with outside sales. Of course, that value becomes the value for

depletion purposes and when there is no sale at the well head, the third-party equivalent is used. And in that case for crude the posted field price is used. And with respect to natural gas, in those years we used the Fiske formula to back into the value from the first-known price which was at the tailgate of the gas plant.

Q Now does the Internal Revenue Service accept this as a proper measure of value?

A Not only accepts it, they insist on it.

Q Now would you describe the use of posted field prices and the Fiske formula in determining severance tax liability to the producing states?

A Yes. The most of the producing states, the production and severance taxes are based on fair market value at the well head described similarly as to the depletion allowance. And the posted field price and the Fiske formula method of backup to well head gas prices are all accepted and used very widely for determination of those values for severance taxes.

Q Which states impose a severance tax?

A Texas, Louisiana, Oklahoma, New Mexico, I suppose, I know Colorado and probably California, I am not positive.

Q And do these states accept the determination of value arrived at from posted field prices and the Fiske formula?

A Yes, they do.

Q Would you describe the use of the posted field prices and the Fiske formula-determined prices for income or franchise tax purposes in the producing states?

A Well, as I mentioned, the determination of the income at the well head for all of these purposes is necessary particularly when you are allocating income to the various states; and the states have always followed fairly closely the federal rules with respect to determination of fair market value. So these states have also accepted the posted field prices and the Fiske formula-type calculation.

Q And would you describe the use of the posted field prices and the Fiske formula in making determinations of values for royalty payment purposes or third-party working interest purposes?

A Well, royalty contracts usually call for the royalty owner reserving a fraction of the fair market value of the minerals as produced. And this, of course, is a factual determination and all settlements that I know of by purchasers or production are made on the

basis of posted field price or the formula determination for natural gas at the well head using the Fiske formula.

By the same token, where you have joint interest owners in the working interest of leases, those settlements are always made between owners where one of the witnesses mentioned that in a typical oil and gas lease where there is more than one owner, one is appointed the operator and usually has the obligation of disposing of the producing on behalf of the others. And those settlements, the sales are generally made and the settlement is made on the basis of posted field price and also in connection with gas at the fair market value under the Fiske-type calculation.

Q And based on your experience do the owners of the royalty interest and the owners of the working interest accept the values so determined?

A Uniformly as far as I know.

Q Would you describe briefly the Internal Revenue Code proportional profits theory on depletion?

A Well, the proportional profits theory of depletion is generally applied to hard minerals and it allocates fair market value of a mineral product that is not

sold at the mine on the basis of the expenditures which are made against it so that each dollar of expenditure proportionally applies to a fraction of the selling price in determining fair market value at the mine.

Q Can you explain the reason for the proportional profits theory being used as to hard minerals?

A There is no better method of determining fair market value at the mine than the proportional profits method that has been devised. And it is statutory with respect to hard minerals in the Internal Revenue Code.

Q Now is this same method used in the oil and gas industry?

A No, it is not.

Q Would you explain that?

A Well, it is not used because there are other sources of determining fair market value at the well head which are more reliable, easier to determine and achieve a more equitable result.

Q And what are these other sources?

A The posted field price and the formula-type calculation for natural gas.

Q Now you have touched on this already but I would like

you to describe a little more fully the application of posted field prices as to crude when the crude is put through the producer's refinery?

A Well, as I said, in order to form a cost base for the products that are, or for the crude oil that is going into the refinery, to put the produced crude and the purchased crude pretty much on the same basis they need a determination. And it is good for accounting purposes to have a determination made of the value of that crude. And so all crude, whether it is purchased from royalty owners and outside mineral interest owners or sources even where the refiner does not have any ownership to put all of those on the same basis, the produced crude is valued at the posted field price going into the refinery.

Q I believe you heard Mr. Carter's testimony yesterday as to the transfer prices of natural gas. Can you tell us from your experience whether the use of transfer prices based upon the determination described by Mr. Carter is consistent with good accounting principals?

A Yes, I am very familiar with the transfer of products from the refinery into marketing; and although there might be some slight variation in the proprietary

aspects of the accounting, practically all of them use the determinations from Platt's Oilgram or other public sources where fair market value can be determined.

Q I think you may have misunderstood my question or anticipated me. I was really asking about the transfer level between E and P and Refining relating to Mr. Carter's testimony as to the determination of gas prices, and I will get to the other one in a minute, but can you tell us from your experience whether the use of transfer prices for gas based upon the determination described by Mr. Carter is consistent with good accounting principles?

A Yes, I am sorry. I did not understand the question properly.

Q Youranswer is?

A My answer is that it is consistent with good accounting. It involves the gas that is transferred from E and P to be used as a fuel source.

Q All right. As long as we got into it, let me ask you the same question as to the transfer between the refining and marketing based upon the Platt's determined prices as described by Mr. Campbell in the evidence yesterday.

A Yes. The question -- the answer there is similar to the one that I made to the question that I misinterpreted. Here again, as I say, there might be some slight variation for proprietary reasons between the

methods used, but practically every company with which I am familiar uses a source such as Platt's Oilgram, a published source to make, or to determine the transfer price from refining into marketing.

Q Based upon your background in the industry and your extensive knowledge of oil and gas accounting, do you have an opinion as to whether or not for purposes of correctly and fairly determining the profits of an exploration-production function, the use of posted field prices on transfers between E and P and Refining gives a result equivalent to a third-party sale price?

A Yes, it is my opinion that the use of the posted field price and transfer price as determined from the Platt's Oilgram and other outside sources gives you the equivalent of a third-party price.

Q Let me ask you if you want to correct that statement -- that reference to Platt's Oilgram in terms of transfer between E and P and Refining. I find that the Fiske formula and Platt's sometimes get interchanged, and I would like to ask you whether you didn't mean the Fiske formula determination in that last statement?

A Yes.

Q Now based upon your experience, would you further describe your experience with multi-functional oil and

gas companies having E and P, refining and marketing functions? I am particularly interested in the functional accounting that they do and whether they followed the policy that previous witnesses have referred to as "functional profitability independence?"

A Yes. Do you want me to discuss that?

Q Yes, discuss your experience with other companies' use of this policy?

A It has been my experience that all companies use the functional profitability independence for measuring the performance of their various operations. They measure their performance of the E and P function by applying posted field prices and Fiske-type formulas to determine the values of the products and to measure the profitability and the success and operations of the personnel, and with respect to the other functions, the refining function, they measure the performance of that operation by having a net income determination by that particular function and carry it over into marketing and each of the other functions, so that they use this for a number of purposes, probably the principal of which is to measure the performance of their personnel and their investments with respect to

those functional operations.

Q Now is this equally true as to companies that have only refining and marketing functions?

A Yes, it is.

Q Now would you comment on whether these functional departments in such companies are generally treated as separate businesses for internal accounting purposes?

A Yes, they are.

Q Now as to the individual functions themselves, based upon your experience do these separate functions have differing capital investment requirements?

A Yes.

Q Do they experience different returns on captial investments?

A Yes.

Q Now would a formula apportionment method which assumed a uniform return on capital investments be realistic to the facts in the industry?

A No.

Q Would a formula method that assumed a uniform net income as a percentage of dollar of sales be realistic as to the facts in the industry?

A No.

Q And do these companies with which you are experienced have the differing percentage net income for differing types of sales?

A Yes.

Q Now in these companies are the individual functional departments treated as seperate profit centers?

A Yes.

Q And separate investment centers?

A Yes.

Q Do the multi-functional companies you are experienced with use posted field prices for transfers?

A Yes.

Q Between E and P and Refining?

A Yes.

Q Do the companies in the industry utilize arms-length price determinations for transfer prices between their refining and marketing functions?

A Yes.

Q And how do they determine this transfer price generally?

A How do they determine the transfer price between refining and marketing?

Q Correct.

A By use of extraneous sources of material, principally the Platt's Oilgram.

Q As auditors of such companies, have you or your firm

tested these transfer prices?

A Yes, we have.

Q Based upon your experience, do you have an opinion as to whether such transfer prices provide an accounting result equivalent to a third-party sale price?

A It is my opinion that it does provide that.

Q Is it or is it not your opinion that such prices can be considered as arms-length and fair and reliable for accounting purposes?

A Yes.

Q Now will you describe the theory and practice of functional profitability independence in the industry, and first of all in the E and P function by individual wells?

A Yes. It has been stated by Mr. Koonce, I believe, that for the computation of depletion we have to arrive at a net, net income by unit of property. That unit of property can take the form of either a well or several wells or in most cases not anything larger than a single oil and gas lease. There are also many types of drilling arrangements that a company will enter into which will make it necessary to account separately for the oil and gas net income from one well as related to other wells on a single

lease, so I would say that within the industr it is practically universal that they are on accountability by wells. In some cases not all the way down to net income, but certainly with respect investment, with respect to ~~growth~~ gross income and some direct expenses.

Q Is there also profit accountability by other segments, such as gathering groups of fields?

A Yes, by combinations of the factors makin up the net income on a specific well, income can be determined for statistical purposes, for example, to determine production from an oil and gas field, and in some instances as has been mentioned, there are several fields underlying a single geographic area, and it is necessary to account for those fields separately for many purposes and to determine the profitability of a district or a division, sometimes there is accountability for the district itself and for a division to compare one division against another.

Q Now, would you further describe the theory and practice of functional profitability independence in the industry as to the net income derived from the E and P Functional Department itself?

A When all of this information is consolidated and there are allocations made of expenses which apply, cost of

the various functions, it is very easy to determine the functional profitability of the E and P function itself.

Q Would you comment on the same line of inquiry as to the refining function?

A Yes. Practically everyone who owns more than one refinery is going to keep a separate set of books with respect to each separate refinery operation. Refineries are not generally in clusters but are separate rather widely geographically, and so it makes for an easy determination of accounting by refineries, and then when you have a number of refineries making up the refining function, you can aggregate all of that information and make your appropriate allocations of items which cross functional lines and you can determine the functional profitability of the refining operation.

Q Does this give you the net income derived from the refining functional departments?

A Yes, it does.

Q Would you comment on the same line of inquiry as to the marketing function?

A Well, the marketing function is somewhat different from the other two in that you can start off your

build-up of your functional profitability with such things as individual service stations. Most companies will have quite a lot of information specifically about a single service station, the investment in it, the volumes that are sold from that station of both the refined products and the packaged products, and tires, batteries and accessories and all of those things so that it is fairly easy to determine all of the accounting data with respect to the single stations themselves. Then as you aggregate within a district the various stations, you can come up with similar profitability information with respect to the district and expand onto the region and to the entire functional division of marketing.

Q Does that include states too?

A Yes, it does. I didn't mention that for state income tax purposes most companies that have multi-state operations will also have the segregation of the districts; for example, down into various state operations.

Q Does this application of the functional profitability independence approach then allow you to arrive at net income derived from the Marketing Functional Department?

A Yes, that is a final result of the combination of all of these individual determinations.

Q Now would you next describe the characteristics of functional unit accountability in terms of the results as to unrealized income derived from each unit?

A As to unrealized income derived from each unit?

Q Yes.

A By use of the transfer price we determine, before there is a realized sale to an outside third party, the income which is derived from the function. For example, by crediting the E and P function with the posted field price of crude being transferred into the refinery, we can immediately determine the profitability without any further determination of what happens to the crude once it leaves the E and P operation.

The same is true with respect to crediting the refinery operation with a transfer price prior to the time that there is actually a sale made to a third party, so that the income is actually derived by the function, whther or not it is realized by sales to outside third parties.

Q Is this an advance of the realization in some cases?

A Yes, it is.

Q Would you comment on the necessity to manage and generate realized income at the corporate level in light of the functional unit accountability discussion?

A It is only when sales are made to outside third parties that there is actually an income realization and a cash-flow and a capital build-up for companies to discharge their corporate obligations and to have investment capital available for the decision as to how the capital should be employed at the corporate level.

Q Now on the same subject will you describe the characteristics of the functional unit accountability as to the recognition of unrealized, derived income which would make possible situs and separate tax accountability?

A As I mentioned previously with respect to the earnings to the exploration and production function, by crediting that function with the posted price of all crude that is discovered and produced in that function, we are not concerned with whether the profit is realized, but we know it has been derived because we have valued it at a price which is an arm's length basis on which it could have been moved in commerce outside of the company-owned refinery operation if it had been made available, so that we do not try at that point to measure the performance of the E and P function by realized income, but we have derived the income by arm's length bases.

Q For what tax purposes is this necessary in the producing states?

A Well, in the producing states ordinarily they are not concerned so much with the realization of profit as they are with the deriving of the profit at the

well head for purposes of making the income determination and the depletion calculations and that sort of thing.

Q Is this also necessary for those producing states that have income and franchise taxes?

A Yes. I was speaking particularly of those states that have income and franchise taxes.

Q And is the same kind of determination necessary for severance taxes?

A Yes, it is.

Q And I think you have already mentioned the royalty and the working interest.

A The severance and the royalty and the outside interest operation regulations are incurred at the time the production is moved off of the lease regardless of whether it is sold to an outside party or it is put into the company's system.

Q As to that portion of the crude that's put into the company's system, the income is not realized at that point, is it?

A That's right.

Q But the states tax it at that point nevertheless?

A Generally that's true, yes.

Q And recognize that it's derived at that point?

A Yes.

Q Would you further comment on characteristics of functional unit accountability and their application to permit management at the corporate level to deal with this concept of functional profitability independence or functional stand-alone policy determinations?

A Well, as I said, the top management of the company, by utilizing functional profitability independence, can measure the operations and performance of the various functions against their own standards and they can also measure them against information which might be available from sources outside the company to measure that company against others. And this is true with respect to each of the functions. By determining the profitability of the refining operation they can compare with companies that have no function other than refining. It's both for an internal measurement of performance and it's also for the purposes of measuring competition among competitive businesses.

Q Would you describe the work you have done to prepare yourself for your testimony in this case relating to the specific accounting practices of Humble during

the year in issue?

A Yes. I have, over the last two years, conferred on numerous occasions with most of the people who have appeared here in connection with this proceeding. I have had several conferences with other executives of the company to determine for myself such things as the implementation of the company policies regarding posted field prices, Fiske formula-type calculations, Platt's Oilgram and that type of thing.

I have also taken the information with respect to the income tax returns and have compared them back to the books and records; and I have reviewed the computations that have been made, some of which have been submitted here as exhibits.

Q What additional reviews did you make in connection with industry practices?

A Within my own organization to recheck some of my thinking with people that work on a day-to-day basis with others of our clients, I have gone back and reviewed these matters to be sure that there was not something that I might be missing from my own personal experiences.

Q Are you familiar with Humble's corporate structure

and its functional operations?

A Yes, I have.

Q And have you heard or read the testimony to date at this hearing?

A Yes, I have.

Q Considering the oil and gas industry's accounting factors you have already mentioned and considering the internal accounting principles of multi-functional oil and gas companies you have also discussed, would you comment upon your review and tests of Humble's accounting and reporting procedures for the years 1965 through 1968?

A Well, as I mentioned, I went back to the basic accounting information that was prepared by the Accounting Department to determine for myself whether I considered this to be the type of thing that was usual and customary to be found among businesses within the industry; and I found it to be that Humble does use a system of accounting and its functional profitability independence is very similar to that which is found throughout the industry.

Humble is considered in many instances as a leader in this area and it has very reliable

information.

Q And could you describe a little more fully the nature of your review and your tests in arriving at that conclusion?

A I spent quite a bit of time with Mr. Koonce who is very, very familiar and can answer your questions and lead you to the basic source data in the accounting records for answering your questions. And I had talked with the others about company policy and through him and going back to the accounting records I was able to assure myself that there was a lot of integrity in the use of this information throughout the accounting records of the company.

Q And did this review specifically cover the internal accounting and transfer pricing procedures for the years in issue?

A Yes, it did.

Q Are you satisfied that Humble consistently used posted field prices for recording the transfer of crude from the E and P to Refining?

A Yes, I am so satisfied.

Q Are you satisfied that Humble used third-party contract prices or prices determined in connection with the Fiske or an equivalent formula for the

transfer of gas to the Refining Department?

A Yes.

Q Are you satisfied that the company used Platt's or an equivalent calculation related to prices for the transfer from Refining to Marketing?

A Yes.

Q Would you comment upon your review and tests as to Humble's separate accounting returns filed in Wisconsin for the years 1965 through 1968?

A Yes. I took those returns and went to the accounting data of the company from which it was prepared and checked on a line-by-line basis for all of those items that were accounted for separately with respect to the State of Wisconsin. And as has been mentioned before, there are certain items of expenses which have been allocated from the Midwest area and others like advertising that have other forms of allocation; and I checked the method of allocation of those expenses to the separate return and I have satisfied myself with respect to those returns that were prepared and filed.

Q So I take it that that would include the fact that you were satisfied with the accounting for the Wisconsin sales and cost of sales?

A Yes.

Q And for the accounting for the direct recording of expenses?

A Yes.

Q Were you also satisfied that the expenses that were allocated, and I think those have been illustrated on an exhibit in this case --

A Yes.

Q -- that these were allocated consistent with good accounting principles?

A Most of those were allocated on the basis of the sales realization method.

Q And are you satisfied and do you have an opinion as to whether or not the returns fairly reflect the results of Humble's Wisconsin operations on a basis consistent with generally accepted principles of accounting consistently applied?

A Yes. It is my opinion that those returns on a separate accounting basis do properly reflect the operations of Humble in Wisconsin.

Q Now would you comment upon your review and the tests you made of the State's audits of Humble which are in issue in this case?

A I reviewed quite extensively the audit report of the

examination performed for the years 1965 through 1968.

Q And did your review reveal whether or not the State respected the integrity of Humble's internal determination of the net income derived from its E and P function?

A Yes. There were several instances that could be checked back to the accounting records where the auditors used that functional net income for purposes of making their own calculations.

Q Now based upon your broad experience in the oil and gas industry and upon your background and familiarity with Humble's operations during the years in issue and in reliance on the record in this case to date, do you have an accounting opinion considering the industry's accounting factors and the internal accounting principles of Humble's multi-functional operation as to whether, during the years in issue, Humble's operations conformed to accepted Internal Revenue Code state and industry external and internal accounting and tax reporting procedures in all respects?

A There is excellent integrity in the accounting records of Humble Oil and Refining Company; and I personally

believe that those records are entirely accurate for purposes of the Internal Revenue Code and for purposes of making accurate functional determinations of net income within the company.

Q Do you further have an opinion as to whether Humble conformed to the internal accounting and transfer pricing procedures accepted by the industry to properly reflect the policy of functional profitability independence?

A It is my opinion from my review that they can determine accurately that information.

Q And, further, do you have an opinion as to whether Humble's accounting and reporting isolated and supported the identification of all net income, first of all, derived at the situs of production for the E and P function?

A Yes.

Q And, secondly, the net income derived at the point of operation for the refining function?

A Yes.

Q And, thirdly, the net income derived at the point of operation for the marketing function collectively?

A Yes.

Q And for the State of Wisconsin separately?

A Absolutely.

Q And do you further have an opinion as to whether each of Humble's Wisconsin returns on a separate accounting basis were valid in terms of proper internal accounting principles consistently applied?

A Yes.

Q You have an opinion and your opinion is --

A I have an opinion and my opinion is yes.

Q Do you further have an opinion as to whether or not the net income derived by Humble's E and P function was in any accounting sense created even in part by business done in Wisconsin?

A It is my opinion that there is no relationship in the net income of the E and P function and business done by Humble in the State of Wisconsin.

Q Under generally accepted principles of accounting, was such income fully earned at the point where the oil and gas were available for ~~this position~~ disposition by the E and P function?

A Yes.

Q Under generally-accepted principles of accounting, do the refining and marketing functions serve to increase or decrease the amount of Humble's production income?

A They do not.

Q Neither?

A Neither .

Q Do you have an opinion as to whether the present application by the State of its apportionment formula in effect produces Wisconsin taxable income by subjecting Humble's E and P and Refining net income to tax year in this state?

A It is my opinion that the formula that was used in connection with this ~~product~~ audit does tax a portion of Humble's ~~earnings and profits and~~ exploration and production net income.

Q And do you have an opinion as to whether the application of the apportionment formula here is consistent with a good accounting practice in respect to using a second factor for the cost of manufacturing measured by the selling price of goods produced?

A I would state that I have never encountered that type of a factor before, and it appears highly unusual that that type of a factor would be used in view of the statutory language which requires a three-part formula which does not include that type of hybrid formula that has been called throughout this hearing.

Q Do you have any opinion as to whether the application of the apportionment formula is consistent with good accounting practice in weighting down the cost of manufacturing factor?

A As I said, it is highly unusual and I haven't experienced it before and therefore I would have to state that it is unique and I don't really know that -- I don't see how it applies in this case.

Q Can you explain the impact of weighting down one factor of the three-factor formula in terms of how

the result reflects the activities of that particular company in the State?

A I will see if I understand the question. When you give weights to the various factors and you have factors which do not appear within a state, such as cost of manufacturing, you end up with figures that have very little relationship to the determination of the -- or the application of the formula to the net income within the state.

Q In other words, where there is no cost of manufacturing

A It should have no weight.

Q And by excluding even part of it, you change --

A You change the whole relationship of all of the other factors when you introduce something that isn't present.

Q Now, do you have an opinion as to whether the application of the apportionment formula is consistent with good accounting practice where it employs the assumption that each dollar of investment produces an equivalent return?

A Any formula that uses that assumption has to be questioned.

Q And do you have an opinion on the same basis as to whether the employing the formula of the assumption

that each dollar of sales produces an equivalent dollar of net income and thus our costs are uniform on sales?

A That formula should also be examined.

Q And do you further have an opinion as to whether these assumptions are consistent with the factual pattern in the industry?

A It has been my experience that where a formula apportionment method is used that the formula has been applied as provided within the statutes.

Q But based upon your experience does the industry reflect an equal dollar of net income for each dollar of sale?

A No, I do not believe that it can be said that the industry would give that kind of a result.

Q And does the industry experience indicate an equivalent dollar of return for every dollar of investment?

A No.

Q Now, based upon your experience do you have an opinion as to whether these two assumptions are consistent with Humble's factual situation?

A Certainly not.

MR. TIMKEN: We will take a ten minute recess.

(Recess)

TIMKEN:
MR. ~~RAGATZ~~: You may proceed.

(Question read: Now, based upon your experience do you have an opinion as to whether these two assumptions are consistent with Humble's factual situation?
A. Certainly not)

A I would like to say that I do have an opinion and my opinion is that these assumptions do not apply to Humble Oil and Refining Company.

Q I asked you several previous questions that were premised with the phrase "Do you have an opinion" and you may have given me a singular answer. Would you like to clarify on the record that you meant you had an opinion?

A I do have an opinion in each of these instances.

Q And your opinion was as indicated?

A As indicated, yes.

Q I am not sure whether I asked you whether you had an opinion as to whether the present application by the State of its apportionment formula in effect produces Wisconsin taxable income by subjecting Humble's E and P and Refining net income to tax year?

A Yes, I did state that I believe that the formula which is used by the State of Wisconsin does tax a portion of Humble's E and P net income.

Q Now do you have an opinion as to whether the apportionment formula as here applied produces a meaningful, reliable and reasonable result?

A I do not believe it does achieve that result.

Q Would you explain that answer?

A Well, it was pointed out on some of the exhibits, the portion of the -- the net income determination on a Wisconsin basis that is taxed under this formula is a much higher percentage than with respect to the total operations of the company, particularly in the marketing area.

Q Now in that connection in light of your answer, would you comment upon what has been admitted into evidence as Exhibit 30?

A Yes, Exhibit 30 is a summary for the four years that are involved in this proceeding of the factor attributes that -- as they relate to the Wisconsin factors, and as pointed out by Mr. Koonce, the factors for the Exploration and Production Department contribute 22.6 percent and the income of the Exploration and Production Department on a Wisconsin basis is 74.4 percent, and

to me that type of a distortion gives rise to a question whether or not the application of the formula produces a reasonable result.

Q Would you have an opinion as to whether the application of the formula that produces that kind of variance between the factors attributes and the percent of income could produce a reasonable result?

A It hasn't in this case and I don't see how it could, no, sir.

Q Now would you comment on the mechanical steps involved in the State's formula where ratios are multiplied by ratios? I believe Mr. Koonce pointed out in his testimony --

A Yes, there are several instances in which the formula as it is used applies a ratio to a ratio, and where ratios are used you are in effect using averages or using estimates, and when you apply one against the other you compound the possibility that a result will be achieved which is not reasonable, and when you start using ratios on ratios it is my opinion that the end result must be tested against that formula application to see that a reasonable result is obtained.

Q Now then, do you have an opinion as to whether a formula as applied produced the result which shows

Wisconsin taxable income in a reasonable relationship
to Wisconsin activities?

A I would like to refer to Exhibit 29 in which it shows
that the Wisconsin taxable income pertaining to --
or in relation to Wisconsin sales is 7.5 percent,
whereas on an industry-wide basis computed on a
Wisconsin basis, it is only 3.2 percent.

Q You mean a Humble total marketing basis?

A Humble total marketing basis, yes.

Q Do you have an opinion as to the relationship of those
two percentages in light of my question as to whether
the resilt of the formula shows that Wisconsin taxable
income in a reasonable relationship to Wisconsin
activities?

A I believe to me it appears that Wisconsin is reaching
out to tax income which is not appropriately related
to the State of Wisconsin.

Q I would like to refer to Exhibit 28, Schedule A, which
I believe is in front of you?

A Yes, sir.

Q And I would ask you just generally to comment upon
the comparison between the taxable income assessed by
the State's apportionment method and the separate
accounting results reported by Humble in light of the

question I previously posed as to whether the formula produces a result in any proportion to the -- or in any reasonable relationship to the activities in the State of Wisconsin?

A Well, as I stated previously, I had examined Humble's separate accounting and I have checked the accuracy of that reporting information back into the books and records, and the aggregate of the losses reported for the four years involved on a separate accounting basis is approximately four million dollars, and the taxable income in the audit report is 4.5 million dollars, so the difference between the use of the apportionment method as applied by the State of Wisconsin and the separate accounting method is 8.5 million dollars approximately, and to me that is a grossly inequitable result.

Q Do you have an opinion then as to whether or not that result is way out of proportion to the Wisconsin activities of Humble?

A In my opinion it is way out of proportion to the Humble activities in the State of Wisconsin.

Q In the process of your review of Humble and its policies did you find any evidence whatsoever that Humble shifted profits between its functions during the years

in issue?

A No, I did not. Based on the work that I did, I would consider that there is complete integrity in the accounting records of the company.

Q No further questions.

MR. TIMKEN: Mr. Shapiro, you may cross examine. Would you like a break?

MR. SHAPIRO: Thank you. I think I will proceed and we may ask for a little break.

MR. TIMKEN: Very fine. You may proceed.

CROSS-EXAMINATION

BY MR. SHAPIRO:

Q Mr. Wehner, what formal training or experience have you had in the application and apportionment of State income or franchise taxes?

A Formal training?

Q Or experience, yes, sir.

A I have had approximately 28 years of experience in working with taxation, much of which has been in multi-state operations. Now as you well know, the State of Texas does not itself have an income tax return, but many of our clients in Houston do business which crosses state lines and have done so for

practically all of these 28 years and most of my experience has been devoted to the area of taxation.

Q Has your experience been devoted to the area of the -- to the specific area of the allocation and apportionment of state income and franchise taxes?

A Yes. I will say I have had considerable experience in that area.

Q Isn't it true that accounting for tax purposes for -- for state income tax purposes is quite a different matter than accounting for financial and management purposes?

A That is true.

Q Isn't it true that for overall apportionment purposes, functional accounting is not relevant but that the overall net profit is the significant figure?

A I don't think I am qualified to answer that question.

Q You testified regarding Exhibit 29, and that is a comparison, and do you have that before you?

A Yes, sir, I have it in front of me.

Q I believe the gist of your testimony was that that is a valid comparison as set forth on that exhibit. I would like to ask you if we used the 7.5 percent for percent of net income for dollar of sales comparing Wisconsin sales and Wisconsin assessed taxable income --

A Yes.

Q -- and then over toward the right instead of the three columns on the right, we would use total company sales as compared with total company net income, and then get a percentage, and would that represent a valid comparison?

A It would represent one means of testing the reasonableness of the application of the formula.

MR. SHAPIRO: I will renew my request for five minutes.

MR. TIMKEN: You may have five minutes.

(Recess)

MR. TIMKEN: Mr. Shapiro, are you ready to proceed?

MR. SHAPIRO: Yes, sir.

BY MR. SHAPIRO:

Q Mr. Wehner, you also commented, I believe, on Exhibit 30?

A Yes, sir.

Q Is it not true that the thrust of the data in Exhibit 30 is based on a functionalized accounting system as is indicated by the breakdowns on the succeeding pages?

A That the thrust of it is based on a functional accounting?

Q Yes, that the import of this exhibit is based on functional accounting?

A The underlying information that makes up the summary on the face of Exhibit 30 is based on functional accounting, yes, sir.

Q Yes. Now I believe you also testified that you have had experience in apportionment and allocation of state income taxes?

A Yes.

Q How would you define a unitary business?

A A unitary business is, in my opinion, a series of

business operations which are so related that they are completely independent and contributory to each other in the final business operation.

MR. SHAPIRO: I have no further questions.

MR. TIMKEN: Mr. Ragatz, any re-direct?

MR. RAGATZ: Briefly.

REDIRECT EXAMINATION

BY MR. RAGATZ:

Q On Exhibit 29 Mr. Shapiro asked you to compare the 7.5 per cent return on Wisconsin sales per the Wisconsin audit within concept the total company's operations and its total net income. Do you have an opinion as to whether such a comparison would be a comparison which might be characterized as apples and oranges?

A Well, not having seen such a comparison and not having it in front of me, it's difficult. But where we have Wisconsin with solely a marketing operation and the company having a very functional operation in total, I do believe that it would not be a valid comparison overall.

Q Now referring to Exhibit 30 and also Exhibit 29, could you describe the impact on one dollar of net income in terms of the percentages shown on Exhibit 30 and compare it to the 7.5 per cent shown on Exhibit 29?

A Well, as Mr. Koonce pointed out, the application of the factor attributes for the State of Wisconsin, that if they drew in one dollar of income it would draw in 74 cents of income from the Exploration and Production Department, 14 cents from the Marketing Department, 7 cents from the Refining Department and roughly 4 cents from other departments.

And when you look over and see that on Exhibit 29 and know that Wisconsin is purely a marketing operation, you can see that the comparison of the 7.5 per cent to the 3.2 per cent is a result of their formula attaching a large segment of the Exploration and Production Department's net income.

Q One final question. When Mr. Shapiro asked you to define a unitary business, I wasn't sure whether you said interdependent or independent; do you recall?

A I don't think I used the word.

MR. RAGATZ: Would you want to read back his testimony on that?

(Answer read as follows: Answer. A unitary business is, in my opinion, a series of business operations which are so related that they are completely independent and contributory to each other in the final business operation.)

THE WITNESS: I thought I said that they are so dependent on each other. I am sorry.

Q That's what you meant?

A Yes.

MR. RAGATZ: No further questions.

MR. TIMKEN: Mr. Shapiro?

MR. SHAPIRO: No further questions.

MR. TIMKEN: Thank you, sir. You are relieved.

(Witness excused)

MR. TIMKEN: Mr. Ragatz?

MR. RAGATZ: At this time I find myself in the pleasant position of being ahead of schedule and I didn't have my next witness scheduled to be in court until tomorrow morning. So I would be happy to

agree to have Mr. Shapiro commence with his case, if that's agreeable to him, or to wait until tomorrow morning when I can put my other witness on, whatever the Commission's pleasure is.

MR. TIMKEN: I should inform you, Gentlemen, that this Commission, in anticipating that we may not be done this week, arrived at the decision that if we are not done by Friday we intend to schedule Saturday. The alternative is to carry over two or three weeks because we don't have any place to fit in the postponement. And I point that out to you gentlemen so that you can take that into consideration in this discussion now.

Is that your last witness, Mr. Ragatz?

MR. RAGATZ: We have one more witness and, as I say, that will be the first witness that I have tomorrow morning.

MR. TIMKEN: So do you prefer to adjourn until tomorrow morning or would you prefer to start your case now?

MR. SHAPIRO: Well, if I could have

about 10 minutes I would just as soon go ahead.

MR. TIMKEN: Sure. We will take a 10-minute break.

(Recess taken at 3:07 p.m.)

STATE OF WISCONSIN

WISCONSIN TAX APPEALS COMMISSION

* *

EXXON CORPORATION, (f/k/a Humble Oil and Refining Company),

Petitioner,

vs.

Docket No. I-3806

WISCONSIN DEPARTMENT OF REVENUE,

Respondent.

* *

CERTIFICATION

KAREN A. CHERRY
MINDLA COMINS
LORETTA PETERS,

hereby certify that as the duly appointed reporters, we took in shorthand the testimony and proceedings had in the foregoing matter on the 8th day of October, 1974, and that the attached is a true and correct transcription of said shorthand notes and of the whole thereof.

Dated this 8th day of October, 1974.

Karen A. Cherry

Karen A. Cherry

Mindla Comins

Mindla Comins

Loretta Peters

Loretta Peters

STATE OF WISCONSIN

WISCONSIN TAX
APPEALS COMMISSION

*

EXXON CORPORATION, (f/k/a Humble
Oil and Refining Company),

Petitioner,

-vs- Docket No. I-3806

WISCONSIN DEPARTMENT OF REVENUE,

Respondent.

*

TRANSCRIPT OF PROCEEDINGS in the above-entitled matter held before the Wisconsin Tax Appeals Commission, in Room 229, City-County Building, Madison, Wisconsin, on the 9th day of October, 1974, commencing at 9:30 in the forenoon.

PRESIDING: R. J. SMRZ, Chairman
THOMAS R. TIMKEN, Member
JOHN P. MORRIS, Member
ALSO PRESENT: JAY C. GITCHELL, Hearing Examiner

A P P E A R A N C E S:

BOARDMAN, SUHR, CURRY & FIELD, Attorneys at Law, 131 West Wilson Street, Madison, Wisconsin, by THOMAS G. RAGATZ,

and

McBRIDE, BAKER, WIENKE & SCHLOSSER, Attorneys at Law, 110 North Wacker Drive, Chicago, Illinois, by LLOYD M. McBRIDE and PAUL D. FRENZ,

and

ROBERT E. TANNEHILL, Tax Attorney, Exxon Company, Houston, Texas, appearing on behalf of Petitioner,

IRVING F. SHAPIRO and ROBERT M. FINLEY, Tax Counsel, Wisconsin Department of Revenue, 201 East Washington Avenue, Madison, Wisconsin, appearing on behalf of Respondent.

MR. TIMKEN: Back on the record.

MR. RAGATZ: The petitioner calls Professor Ezra Solomon.

PROFESSOR EZRA SOLOMON,

called as a witness, having been duly sworn under oath, testified as follows:

DIRECT EXAMINATION

BY MR. RAGATZ:

Q State your name for the record, please.

A Ezra Solomon.

Q Where do you live?

A Stanford, California.

Q How old are you?

A Fifty-four.

Q Would you review your academic training for us, please?

A I graduated with a Bachelors Degree of Economics at the University of Rangoon, Burma, and then I came to this country after World War II to do graduate study and completed my Ph. D. at the University of Chicago in 1950.

Q Would you review the academic positions that you held for us, please?

A Outside of some small amount of teaching in Burma before World War II, it has been mainly at the University of Chicago where I served on the Faculty from 1948 to 1960, and since 1961 I have been Professor of Finance at the Stanford University, California, and since 1965 I have held the Dean Witter Professor of Finance, Stanford University.

Q What was the major subject of your Ph. D.?

A Economics and finance.

Q Is that your major interest at this time?

A It still is my major interest.

Q And in your present position are you teaching at the graduate level or undergraduate level?

A Entirely at the graduate level at the time.

Q Would you describe your professional activities and publications?

A I served as editor of the Journal of Business from 1953 to '57. I have served on the Editorial Board of the Journal of Finance. I have been a Consulting Editor in Finance, Prentice-Hall, and served as the General Editor in a series called Foundation of Finance Theories.

I have served on the Editorial Board of the Journal Quantitative and Financial Analysis,

and on the Board of a British Journal called the Journal of Business Finance. I have published articles and books in the field. The major books are The Theory of Financial Management in 1963 into seven foreign languages, That Management of Corporate Capital published in 1960; a book on Money and Banking, which has gone into five editions, a parallel book called Money and Banking in Canada, a book on Metropolitan Chicago.

Q Have you also published articles in professional journals?

A Yes, I have.

Q Would you review your government service experience?

A My major full-time service with the goernment was that I was a member of the President's Council of Economic Advisors from 1971 to 1973, but I have also served on other activities.

Prior to going to the Council I was a member of the Presidential Commission on Financial Structure and Regulation. I have served as Consultant and am still serving as Consultant to the Council of Economic Advisors; as a Consultant to the Secretary of Treasury, and the Board of Governors of the Federal Reserve System.

Q Now, in addition to these activities, have you been active in governmental energy activities?

A Yes, I participated in a large number of the Federal Power Commission Area Rate proceedings on the price of natural gas.

Q Would you review your business experience for us, particularly as it applies to the oil and gas industry?

A Well, in addition to serving as a Consultant to a number of companies on the area rate cases, during my stay on the Council itself, I was a member in charge of energy matters and that is the limit of my direct experience with the companies.

Q Would you mention a few of your other consulting positions?

A I am now serving as a consulting economist with Heiden, Shearson and Hammill. I'm sorry, it is Shearson, Heiden and Stone, a large Wall Street brokerage company. I serve as a consulting economist to the Wells Fargo Bank, to the Castle and Cooke, Incorporated, to a group of economic consultants called Management Analysis Center. I have served as a consultant to the American Institute of Certified Public Accountants, and on occasion to the Financial Accounting Standards Board.

Q Have you served at any time as a consultant to any committees of Congress?

A Yes, I have served as a consultant to the United States Senate Committee on Banking and Currency.

Q How about any foreign governments?

A I have served as a Consultant to the Government of Mantitoba. I should mention that I did work for the Department of Energy for our own government here at one time, and I was a member of the Commission on Higher Education for Australia.

Q In addition to your academic activities in this country, have you lectured elsewhere in the world?

A Yes, I have. I have visiting professorships in this country as well as abroad, in 18 or 20 countries.

Q In connection with your business experience in the oil and gas industry, would you describe the types of companies that you have had experience with?

A Well, they were all of the companies who were technically respondents in the area rate proceedings. The cases were tried collectively for all of them and most of the major companies that were involved produced gas.

Q I assume this is a matter of public record so there will be no confidentiality problem. Could you mention

the names of some of these companies?

A Yes, Phillips was certainly one; Exxon was, and prior to that Humble.

Shell was involved, Standard of Indiana, and Standard of California.

Q I presume these are all multi-functional multi-state corporations in the industry?

A Yes, although the so-called producers group technically represented all producers in the area that was being covered.

Q What background have you had with the Exxon Company U.S.A., and its predecessor, the Humble Oil and Refining Company prior to this case?

A Only my experience in connection with the natural gas cases.

Q Would you describe that in a little more detail?

A Well, these cases presumably were attempts to derive a fair price for natural gas at the well head, and it involved the whole issue of an appropriate rate of returns and an appropriate basis to be used and the efficiency of production of gas.

Q How long did this continue?

A Well, the first one began in 1961 and went on almost continuously and still are going on.

Q How long have you been following the activities in the oil and gas industry?

A Since 1961.

Q Now I would first like you to talk about three terms: unitary, integrated and integral parts; and perhaps, first, you could explain these terms in the common layman's sense in which they are sometimes used and then explain them as an expert economist, if you would.

A Well, like so many terms in the applied social sciences, these three terms that you name don't have an objective, unambiguous meaning. They have to have a meaning within a context in which they are used.

For example, in the purely layman or literal sense of the word, unitary applies to anything from the atom to the whole universe in fact. The universe has the word "uni" in it, too. In other words, it is thoroughly meaningless because it could apply to anything.

And the same thing could be true of the word, integrated which means to bring together. Used in a business context, all businesses, small and large, from the family restaurant onward

integrate or bring together several different processes or operations. So there, too, it has no particular meaning. Everything is integrated; everything is unitary.

One has to move from that kind of literal dictionary meaning to a more functional economic meaning. And there I think the essence of a unitary operation refers to that collection of activities which can feasibly be conducted as an economic unit in the marketplace. It may itself consist of many little steps, but they have to be performed collectively to provide economic viability. Such a company would be a unitary company, meaning each operation is essential to its viability in making a profit at all and you cannot do without any of them.

Q Well, now, are the terms integrated and unitary synonymous?

A No, not in an economic sense. If you use the word unitary in the sense that I have just described it for economic purposes as that minimum unit which provides economic viability, then integrated has in effect the opposite sense of unitary. We refer to an integrated company such

as Exxon as being a company which brings together unitary groups that could survive independently but are brought together for purposes of providing greater economies of scale of one kind or the other.

Now the act of integrating in an economic sense is not to be confused with the purely technical sense of bringing together. In an economic sense you bring together unitary businesses and you call that an integrated company.

Q Now would you explain the difference between the use of the term vertical integration and the use of the term horizontal integration and relate that to this discussion?

A Well, when you bring together several stages or unitary businesses which perform services at several stages in an industry, you call that a vertically integrated firm. For example, if you had a cattle-feeding operation and then you decided to go into a meat-packing operation, which is a further stage of production, or even further into producing specialized meat products like Oscar Mayer, then you would have a vertically integrated firm in the meat industry.

Likewise, in the steel industry you

could refer to vertical integration either forwards or backwards. You integrate backwards if you are a steel company by acquiring sources of iron ore or the transportation to bring the iron ore to your steel mills; or you can integrate forward into converting your steel into fabricated products.

Horizontal integration refers to the combining of unitary businesses that produce similar products, not products at a different stage; and a typical horizontally combined business might be a chain of department stores all of which sell roughly the same product and you combine them all under one corporate shell.

Q Going back to the word unitary for a minute, what would you say is the essential ingredient for an economic unit to be considered unitary?

A I would say there are several criteria you could use, but one of them would be the essentiality of each component part of that unit to the viability of the unit. This would be one test of the fact that it was a unitary corporation.

Other tests could exist. One, for example, would have to do with the availability of the perimeter of this unit we are talking about

of a price for the output of the unit. There has to be a well-established price for whatever product that unit produces. This would give us the perimeter that bounds a unit.

A third approach would be that if the substantial part of cost of producing that product which has a price are easy to identify in terms of that unit's activities, that would create a unit in my opinion.

So there are three things, the essentiality of each component part one to the other, the presence of a firm and clean price for a product at that stage and the presence of identifiable costs for those operations.

Q Now does the element of essentiality include the idea that it cannot be feasibly severed in an economic sense?

A Yes.

Q Now is the concept severable or severed, does it have to be severed in order to be unitary or if it is severable, is that sufficient?

A No. I am not quite sure whether you are talking about the component part of the unit itself. A unitary business has many component steps. If

those steps have to be performed in combination, that group of steps is the unitary business.

Q If you could segregate out one step and perhaps substitute that by purchase from the outside or sale to the outside, would that step be considered part of the unitary business?

A It would vary from one business to another. I say the definition cannot be precise here. Generally a unitary business is one that performs all of the essential steps required to keep it viable and it doesn't perform anything else that is not essentially required for the production of that product or that commodity.

Q Now would you relate that definition now to your definition of integrate?

A Well, by integrated I mean a combination under one corporate management of many unitary businesses. If the unitary businesses are all in the same line of activity, we call it a horizontal integrated firm. If they are at successive stages in the business, we call it a vertically integrated firm.

In other words, an integrated firm consists of several unitary businesses.

Q Which are not necessarily unitary as to each other,

just unitary as to themselves?

A The whole thing is not unitary, no. The units are these parts that are combined in forming a corporation.

Q Now would you distinguish between the term integrated and the term integral?

A This again, while it is almost precisely the same word, the meanings are almost exactly the opposite of each other.

When you are referring to something being an integral part of something in an economic sense you mean it is an operation or a process which cannot be done without for that unit to function. And indeed the very nature of an integrated firm, as we use it in economics, is that you bring together units that need not belong together, that can very well exist not in combination with each other.

It's entirely possible to have a livestock feeding operation without having a packing house. It's entirely possible to have a packing house without having a livestock feeding operation. And it's possible to be a sausage manufacturer without having either of those two things. If

you do have such a vertically integrated firm, you are bringing together -- not forcibly, but a man is bringing together things which naturally don't have to be together.

Q Can there be an integral part without there first being a finding of unitary?

A Not in my opinion. You have got to find that something is unitary in order to identify that which is an integral part of that unitary business.

Q I would like to give you a couple of hypothetical examples so that you can illustrate the definitions we have just talked about.

My hypothetical involves a large corporation having its headquarters in Chicago. This corporation has two divisions, each of which constitute a separate business. The Chicago Division operates a plant which makes and sells garbage trucks. The Madison, Wisconsin Division operates a retail store selling women's fashions.

Now this corporation operates in one corporate entity and it operates both divisions under a common name. Let's call it Solomon's, has one Board of Directors, has one Chairman of that Board, it has one president, it has common officers

except that two of the vice-presidents have specific assignments, one to each division, both of these vice-presidents being members of the Board of Directors.

Now based upon those facts, do you have an opinion as to whether that hypothetical corporation would come within your definition of unitary?

A No, it would not. Each of the divisions would be a unitary business and the corporation would be a conglomerate, I imagine, which combines these two. By very definition a corporation or a firm has single management or single name, but this doesn't make the corporation unitary in the economic sense we are using.

Q Now would it change your conclusion if this corporation had a common Planning Department?

A No, I imagine a Planning Department is a necessary adjunct of a Board of Directors. If it has one Board of Directors it ought to have a Planning Department.

Q Would it change your conclusion if this corporation also had a common Secretary's Department?

A No.

Q If it had a common Treasurer's Department?

A No.

Q If it had one controller?

A No.

Q If it had one Tax Department?

A No.

Q If it had one Law Department or House Counsel?

A No.

Q It it had one Public Relations Department?

A Again, no.

Q And if it had one Employee Relations Department?

A No.

Q If it had combined miscellaneous staff services at the corporate level?

A If there were staff services, no, it wouldn't change my mind that these were two separable unitary businesses under one corporate shell.

Q Now do any of these criteria I have just discussed in themselves indicate that that corporation would be classified as unitary?

A No.

Q Now do all of the criteria combined change that conclusion?

A No.

Q And I guess you have already said whether any of these facts make the total corporation business unitary?

A They do not in my opinion.

Q Now let's take another example of a vertically-integrated corporation composed of separate unitary businesses. Perhaps your example in the raising and feeding of livestock, the packaging house and so on, if that kind of a business had a common name, common board of directors, common chairman and president and officers, does that make that total corporation business unitary?

A No.

Q And if that vertically-integrated business had the other criteria that I have just gone over with you, common Planning Department, corporate Secretary's Department, Treasurer's Department, controller, Tax Department, Law Department, Public Relations Department, Government Relations Department, Employee Relations Department or other business staff services, would that make the vertically-integrated corporation one unitary business?

A No.

Q Now, if you added to that the fact that there was brand identity as to that vertically-integrated business, would that change your conclusion?

A No.

Q And would brand protection make any difference?

A No.

Q Or quality control as to product?

A No.

Q Now what if that vertically-integrated business had common capital budgeting at the corporate level? Would that make any difference?

A Again, no, that is why you have a corporation.

Q What if this vertically-integrated business operated across state lines? Would that make any difference?

A No.

Q I would like to, in order to put this matter now into context, read to you briefly from the Statute involved in this case which is Section 71.07(2): "Persons engaged in business within and without the state shall be taxed only on such income as is derived from business transacted and property located within the state. The amount of such income attributable to Wisconsin may be determined by an allocation and separate accounting thereof when the business of such

person is not an integral part of a unitary business," and then the statute goes on. As I read this statute it requires a factual determination as to the term "unitary" and as to the term "integral part." Now as an economist, at my request have you studied the use of these terms and the statutory context?

A Yes, I have.

Q Can you please explain the factual considerations involved in making the determinations required by the statute?

A Well, these are, as I have explained, dormant terms that have both literal connotations and dictionary connotations as well as what I regard as meaningful, functional economic connotations, and from the point of view of the latter basis, the economic connotations, I would say those three criteria I mentioned earlier would be the useful ways of limiting what is a unitary business and what is not, and these were the criteria that -- if there is a clear price available for the product of this unitary business, then everything inside that price is a unitary business. However, if the company we are talking about is an integrated company, either a horizontally-integrated company or a vertically-integrated company or a conglomerate

consisting of many unitary businesses, I think one could draw the line between the total corporation and the component unitary businesses within it in terms of — this is what I call "price factor."

If the individual component units are producing a product that has a well known price available daily or hourly or what have you, then that component is unitary, but the whole thing is not.

Q Now do these factual considerations involve your definitions of the word "integrated" or "integration"?

A Yes, I would use the word "integrated company" in the sense I have been using it, a combination of unitary businesses that doesn't have to be that way. The unitary businesses could exist on their own or they could exist in some different combination than the combination encompassed by the company involved. It is not essential that the corporation as a whole have all the unitary businesses it does have. It could get along fine with fewer or more.

Q On that subject would you comment on the composition of the oil and gas industry as to the types of companies and the functions that they have that make up the industry and relate that to your definition?

A Well, the oil and gas industry has a large number of companies ranging all the way from what I call unitary businesses that are performing essentially at one stage of the total industry's operations, all the way up to highly vertically, horizontially, internationally integrated corporations, and you can think of many examples from each of these fields. They are more or less the pure producing companies whose product is crude oil and sometimes natural gas. These are unitary companies essentially. They may well be horizontally integrated, as well.

You may have companies which are essentially only refiners. They purchase their crude oil and they sell their products to some other marketing groups.

There are some which are only marketers -- only marketing companies. There are some which combine marketing and refining, some which combine all three stages, production, refining and marketing, and the latter group all called the fully-integrated companies. Most of the large ones are fully integrated companies.

Q Now again, just to be sure I am clear on this, the use of the term "fully integrated" is not the same

as saying that the ~~difference~~ business is unitary.

A No, precisely the opposite.

Q I would like to read you next from the Department of Revenue's Corporation Section Training Manual, and these chapters have been admitted into evidence in this proceeding as Exhibit 10a, and I am referring specifically to Page 323 of that manual, and I believe it is in front of you, and in the middle paragraph is a statement on"unitary" that I would like to read to you: "A unitary business is one which operates as a unit. Its business cannot be segregated into independently operating branches. Its operations are integrated and each branch is dependent upon and contributory to the operation of the business as a whole."

Would you comment on that definition in light of your testimony?

A Yes. It fits what I am talking about in the way of a unitary business. The unitary business, as I pointed out, is one where the component part of that business cannot be separated into viable independent activities, which means that each component activity is dependent upon some other component activity, contribution runs both ways. This is the minimum

level at which you can operate that and stay in business, given the economic condition that we have. I would agree to the statement.

Q Would you comment on the use of the word "integrated" in that definition?

A Yes. The word "integrated" in this definition is being used in what I call the laymen's sense of the word that it is bringing together the essential components required to comprise a viable entity. It is not being used, I think, in the sense that I have been using it in connection with vertical integration, horizontal integration or conglomerate integration.

A (Continuing) I might add that I would agree with the statement including the use of the word "integrate" if you would say its operations are naturally and/or inevitably integrated rather than integrated by the act of man for other reasons.

Q The definition says that each branch is dependent upon and contributory to the operations of a business as a whole. That would appear to be two requirements.

Would you comment upon these requirements?

A There is reciprocal dependence of each component process on other components processes. You can't have one without the other in the same sense that there is no point on making just left shoes without making right shoes. The saleability of them for the most part depends on making both.

Q Would that term be synonymous with your previously-used term of "essentiality"?

A Yes.

Q And a vital part of the whole?

A Correct, vital, necessary; that if you removed part of a process from within what I called a unitary business, it is likely to operate at a loss or not have a market for its products.

Q Would you comment upon the contributory requirement?

A Well, it is the other phase of the dependent one, part of it. One branch is called one process, one operation. One depends on the other and the other one depends on the other one, and each mutually contribute to the other and depend on the other.

Q Do you view these as two requirements?

A Yes, I think it is a useful test to look mutually between processes within what I call a unitary business.

Q In applying that kind of definition would you comment upon what impact the operation of a business across state lines would have?

A It would have no differences as far as the economic definitions are concerned.

Q The fact that the business is multi-state, does that make it unitary?

A That does not make it unitary at all.

Q In preparation for your appearance here today I would like you to describe the background which you obtained in the matter at issue here; first perhaps telling us how long ago you were engaged?

A Well, I was engaged about a year ago, if I remember

right. Mr. McBride came to see me at Stanford and we talked about the case, and I agreed to participate and have since been following the development of the case. I have reviewed, for example, the transcripts up to yesterday.

Q Up through yesterday?

A Yes.

Q What other background have you obtained in the case?

A Well, we had several meetings of the people who were going to serve as witnesses in the case and discussed the issue of semantics involved in the case and the economic concepts.

Q How many conferences did you attend, do you recall?

A I think I have had three conferences in all.

Q And have you been provided with documents related to the case?

A Yes, I have.

Q Have you examined the documents?

A Yes.

Q Have there been any other background materials that you have examined?

A Well, I read, in addition to the documents that you sent me, whatever books I felt might be relevant

to the oil and gas industry; at least I might say
I reread them.

Q Are you familiar with any previous court decisions in the area?

A Yes, I read one document which provided a run-down on the previous court decisions.

Q And did that include the Minnesota Skelly case, do you recall?

A It did.

Q Have you reviewed the functional organization of Humble?

A Yes, I have. One of the documents I was provided with contained details on the functional organization of Humble, and then there was Mr. Luper's testimony a few days ago.

Q Have you also participated in conferences where that organizational structure was discussed?

A Yes. One of the meetings we had Mr. Luper was present, and we were talking about his testimony.

Q Are you familiar with the functional organization of other members in the industry?

A Yes.

Q I believe you indicated that you have reviewed all the testimony to date in this hearing?

A Yes.

Q Now, based upon your extensive background as an economist, your experience in the oil and gas industry, and your reliance upon the record in this case to date, do you have an opinion on whether during the years 1965-'68 Humble was an integrated company?

A Yes, it was an integrated company.

Q Do you have an opinion on the same basis as to whether Humble was a unitary company?

A No, by my definition. If it is integrated, it is by definition not unitary.

Q And on the same basis do you have an opinion as to whether the functional operations of the Humble Exploration and Production Department, the Refining Department and the Marketing Department were carried on as separate businesses?

A Yes, these are three separate unitary businesses, and if I remember right, there were even more, but these are the three major important stages that a verticially integrated company combines.

Q Each stage, E and P, Refining and Marketing, you would say were separate businesses?

A Yes.

Q On the same basis do you have an opinion as to whether or not the Wisconsin Marketing operations were an integral part of the Humble E and P function?

A No, they are not.

Q Did you find any economic dependence between the Wisconsin operation and the E and P Department?

A No, none whatever. It appears that Humble's E and P Department was a functioning unit even before there were any Wisconsin operations.

Q Could it have been feasibly economically severed from the company without damaging the Wisconsin operations?

A I missed the question.

(Question read)

A What is the "it" in the question?

Q The E and P Department.

A Could Humble's E and P Department sever its relationship with the Wisconsin operation without affecting the Wisconsin operation?

Q Right.

A Yes, I imagine it could.

Q And could the Wisconsin Marketing operations have

been severed without damage to the E and P function?

A Yes, the Wisconsin Marketing end of it didn't exist for a while, and after it existed, it could have been severed without affecting the E and P viability.

Q Now, on the same basis as I previously asked, do you have an opinion as to whether the Wisconsin Marketing operations were during the years in issue an integral part of the Humble Refining Department?

A They were not.

Q Was there any economic dependence in that relationship?

A Not that one could see from the record at all. The Refining Department was a unitary business that could have functioned with or without the Wisconsin Marketing.

Q And so there was no -- or the Department could have been feasibly economically severed without damaging the Wisconsin Marketing operations?

A You could have a Wisconsin Marketing operation without having a Refining Department.

Q Then in other words, there was an ample supply of products without obtaining them from Humble Refin- ~~Market-~~ ing?

A That's correct.

Q Could the Wisconsin Marketing operations have been feasibly economically severed without damaging Humble's Refining Department operations?

A Yes.

Q So there was an ample demand for Humble's Refining products without the Wisconsin market?

A Yes.

Q And going back to the E and P Department for a minute, I take it that in the market there would be an ample demand for crude oil without the Humble Refining Department being in the picture so that Humble's E and P Department could have disposed of its crude oil produced?

A Yes. Many companies exist as crude oil producers.

Q And as to the Refining Department, there was an ample supply of crude oil in the market so that the Refining Department was not economically dependent upon Humble's E and P Department?

A Not in the sense that I am using the word here.

Q And the two departments could have been economically severed on a feasible basis?

A The very fact that refineries exist as independent refineries and producers exist as independent producers and on a fairly large scale suggests that

this can be done.

Q On the same basis that I previously stated to you, do you have an opinion as to whether during the years in issue the Wisconsin Marketing operations were an integral part of Humble's Marketing Department?

A This I find hard to say yes or no. We are ~~not~~ now talking about very similar things, and there is no reason why they would not have been an integral part. It depends on the details involved. There is no reason why they could not have been really separate and not a part of the marketing operations.

Q Would it have automatically followed that the Wisconsin operations would have been an integral part of the Marketing Department?

A Not automatically, no. It would depend on the particular format used.

Q If the Wisconsin Marketing operations could be separated on an economically feasible basis, could the Wisconsin operations be considered non-integral?

A Yes, it could be that just the Wisconsin part of the Marketing function would be a separate business. It can be so.

Q So the test would be whether the Wisconsin Marketing

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operations could be feasibly economically severed?

Yes, that would be the test.

And that would determine whether or not the Wisconsin Marketing operations was an integral part of the Marketing Department itself?

That's correct. It would depend on the circumstances.

MR. RAGATZ: No further questions.

MR. TIMKEN: We will take ten minutes.

(Recess)

MR. TIMKEN: Mr. Shapiro, you may cross-examine.

MR. SHAPIRO: Thank you.

CROSS-EXAMINATION

BY MR. SHAPIRO:

Q Professor Solomon, a company that only operates refineries would have to depend upon its supply of crude oil from third parties and would have to depend on third parties also to provide a market for its refined products, is that not true?

A Correct.

Q On the other hand, an integrated oil company with its own resources of crude and its own marketing outlets would not have to depend upon third parties for raw products and markets for its products, is that not true?

A It depends on its crude balance. Very few of them have exactly the same refining, marketing and production capacities.

Q During a period of short supply of crude oil, is it true that the company which only refines crude oil might not be able to acquire its needs of crude oil to operate its refineries to the extent of demand for

refined products whereas the company with its own crude oil supplies could operate its refineries to meet this demand if its crude oil sources were adequate, is that not true?

A Yes, it would follow if its crude oil sources were adequate.

Q Similarly, could the company with its Marketing Department have a more constant and assured market outlet for its refined products than the refinery company?

A Well, that's the reason they do integrate vertically. They are under the impression that having their own brand-named outlets does give them that stability.

Q Would this promote the more efficient operation of its refineries for planning its production?

A Yes. Again, I think that is the main theory underlying vertical integration that it reduces the bumps and valleys that may occur because of excess demand for crude, excess demand for refined products or insufficient demand. In some cases the total risk of the integrated enterprises is lowered.

Q Professor Solomon, you have studied the structure of the petroleum industry.

A Yes.

Q Have you published articles on the structure and economics of the petroleum industry?

A I have not.

Q Nor have you given any speeches on that subject?

A No.

Q Have you published books on the structure and economics of the petroleum industry?

A Not books.

Q Are you not testifying, Professor, on a theoretical, abstract basis about the petroleum industry?

A Well, I am testifying about the petroleum industry and I am an economist and most economists are theoretical and abstract. But I am not unaware of what goes on in the industry.

Q Are you aware of the variability of the return on investment for the exploration and production function, the refining function and the marketing function for the vertically integrated petroleum companies?

MR. RAGATZ: Objection. I am afraid we are getting into the anti-trust area and I don't see that this has any relevance to the case. I have stated my arguments previously; I won't burden the record with them. But I

feel strongly that this line of inquiry should not be allowed.

MR. SHAPIRO: We are discussing the three principal functions of the integrated oil company.

MR. TIMKEN: Would you read that question back again, please?

(Question read)

MR. TIMKEN: Objection sustained.

BY MR. SHAPIRO:

Q Professor, does the accounting for profits for tax purposes and the accounting for profits for managerial and financial purposes necessarily lead to the same accounting result?

A No.

Q In fact, isn't it quite often true that tax accounting and financial accounting for profits can lead to quite different results for ~~financial~~ functional departments in an integrated operation?

A Well, they can lead to different results for all kinds of companies, not just functional departments. Tax accounting is not the same as financial accounting and

in the aggregate, the total figure reported by the IRS won't be the same figure if you add up all the company's books.

Q If an integrated oil company with sepeate functional operations such as production, refining and marketing, has one function with favorable tax laws, wouldn't it be good business practice to divert as much of the company's overall profits into the low tax operations?

MR. RAGATZ: Objection. That hits anti-trust square in the face.

MR. TIMKEN: Sustained.

BY MR. SHAPIRO:

Q Are you aware of the tax treatment of profits for the different functions of an integrated company?

A You mean the various provisions for things like depletion?

Q Yes, sir.

A Yes, I am.

Q Isn't it true that the tax laws favor the taking of profit of the vertically-integrated company in the E and P function?

MR. RAGATZ: Same objection.

MR. TIMKEN: Sustained.

BY MR. SHAPIRO:

Q Under favorable tax treatment of oil, isn't it entirely possible that refining and marketing would report lower rates of return than production and might even lose money?

MR. RAGATZ: Same objection.

MR. TIMKEN: Same ruling.

MR. SHAPIRO: I have no further questions.

MR. TIMKEN: Any redirect?

MR. RAGATZ: Give me a minute.

I am ready.

MR. TIMKEN: You may continue.

REDIRECT EXAMINATION

BY MR. RAGATZ:

Q Professor Solomon, on cross-examination you were asked questions that seemed to be driving at a dependent relationship between separate functions of an integrated oil company. Would you comment on the concept of dependence in terms of demand and supply in the market itself as to whether or not everybody in business has some dependency on market conditions and distinguish that from an economic dependency in terms of the concept of unitary?

A Well, in the case of a unitary business, the degree of dependence between the sub-components that comprise that unit are very strong. They are essential, they are necessary. You could not feasibly run it in today's economy, or whatever economy we are talking about, without all of those components.

In the case of a vertically-integrated company, the presence of business or unitary businesses within the vertical combination, the dependence is not as strong at all. It is quite a bit weaker. There is, obviously, some advantage for each unitary business belonging in a family of businesses. Size alone does provide some help. That degree of dependende is sort of trivial compared to the interdependence within each unit itself.

Q In the market could you say that the dependence for a refinery would be that there be a supply of crude in the general market itself and that there not be a dependence between ownership of a producing function and a refining function?

A Well, the common ownership of the two functions is not all that important in terms of the demand and supply of the flow of product, either crude or the products that come out of them. There is a well-established

market for crude petroleum. It has a daily quotation. A refinery can buy there, a crude producer can sell there. Likewise, at the refined end there is a clear cut market for petroleum products in which a lot of people engage and in which there are daily quotations so that the degree of dependence is not that great at all.

Q In other words the refinery can get crude from market sources that have no ownership relationship to the refinery and, in turn, can sell its product to the market sources that have no ownership relationship to the refinery?

A Quite. The total demand and supply for crude is balanced. It really doesn't matter where you get it. It's the same kind of thing and you get it at the same price anyway.

Q Mr. Shapiro also asked you about financial accounting, tax accounting. In connection with the separate functions of a vertically-integrated company, is it possible to have separate financial accounting and tax accounting within each function?

A I think it is. If I remember correctly, the way oil companies report for tax purposes, is not exactly the way they report for book purposes. This is true, of course, of a large number of other companies.

Q No further questions.

MR. TIMKEN: Any further questions? Mr. Shapiro?

MR. SHAPIRO: As a preliminary, Gentlemen, I wish to have the record made clear that respondent wishes to preserve its exception to the Commission's ruling that the questions just submitted to the witness should not be answered, and the sustaining of petitioner's objection.

MR.TIMKEN: Your objections are noted and preserved, Mr. Shapiro.

Anything further of this witness?

MR. SHAPIRO: No, sir.

MR. TIMKEN: You are excused,

STATE OF WISCONSIN | WISCONSIN TAX APPEALS COMMISSION

* *

EXXON CORPORATION, (f/k/a Humble Oil and Refining Company),

Petitioner,

vs. Docket No. I-3806

WISCONSIN DEPARTMENT OF REVENUE,

Respondent.

* *

CERTIFICATION

KAREN A. CHERRY
MINDLA COMINS
LORETTA PETERS,

hereby certify that as the duly appointed reporters, we took in shorthand the testimony and proceedings had in the foregoing matter on the 9th day of October, 1974, and that the attached is a true and correct transcription of said shorthand notes and of the whole thereof.

Dated this 9th day of October, 1974.

Karen A. Cherry

Karen A. Cherry

Mindla Comins

Mindla Comins

Loretta Peters

Loretta Peters

STATE OF WISCONSIN
TAX APPEALS COMMISSION

EXXON CORPORATION, Petitioner, vs. WISCONSIN DEPARTMENT OF REVENUE, Respondent.	PETITIONER'S BRIEF Docket No. I 3806

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Medical, and Aviation. (Exhibit 20; Tr. Vol. II, pp. 152-159).

Operating Management was responsible for directing the operating activities of the individual functional segments of Petitioner which consisted of Exploration and Production, Refining, Marketing, Marine, Coal and Shale Oil, Minerals, and Land Management. Each functional segment was organized into a separate department which operated independently of each other operating segment, and was organized in a way so that it could perform pretty much on a stand-alone basis as a separate, single function company. (Exhibit 20; Tr. Vol. II, p. 160). Each operating department was responsible for its own performance both operationally and financially. Each operating department was evaluated separately and independent of each other department from profitability, operational and overall performance standpoints pursuant to Petitioner's policy of functional profitability independence. By having each operating department independently responsible for its functional performance, Petitioner could effectively measure the performance of these departments and improve their operations. Under this plan each Department was in competition with each other department, and this resulted in competition for the available funds for investment in the business activities of each of these operating functions. In effect each of these operating functions was also in competition with other members of the industry operating in the same function. (Tr. Vol. II, pp. 160-162).

The Exploration and Production function was actually composed of three departments, Exploration, Production and Natural Gas. The Exploration Department had the responsibility for the profitable acquisition of reserves of crude oil and gas. This department carried on the exploratory effort needed to find potential oil and gas reserves, and it was responsible for drilling the wildcat exploratory wells to determine whether or not the reserves did in fact exist. The Production Department was responsible for the profitable operation of all of Petitioner's producing oil and gas properties including the operation of the natural gas plants and related facilities. When a well with reserves was found then the Exploration Department turned the property over to the Production Department for further development. The Natural Gas Department was responsible for the profitable purchase and sale and distribution of natural gas. The Natural Gas Department was not a profit center and the records of its transactions were combined with those of the Production Department. The above three departments, Exploration, Production and Natural Gas were considered part of of the Exploration and Production function by the company for accounting purposes. (Tr. Vol. II, pp. 162-164).

The Refining Department was responsible for the profitable operation of Petitioner's refineries and associated facilities which manufactured petroleum products, special products

and petrochemical feed stocks. The Marketing Department was responsible for the profitable distribution and sale of petroleum products through Petitioner's marketing facilities. (Tr. Vol. II, pp. 165-166).

The Marine Department was responsible for the profitable water-borne transportation of Petitioner's petroleum products. This department owned and operated water-borne equipment, ocean tankers and inland waterway equipment, and was also responsible for the chartering of any vessels needed by the department. There were no operations of the Marine Department conducted on the Great Lakes nor was there any shipping in and out of any ports in Wisconsin. (Tr. Vol. III, p. 4)). The Coal and Shale Oil Department was responsible for exploring for, locating and acquiring deposits of coal and shale, and for conducting all operations incident to the mining and milling of those hydrocarbon deposits. None of the deposits were located in nor were any activities of this department conducted in the State of Wisconsin. (Tr. Vol. III, pp. 5-6). The Minerals Department was responsible for the exploration, discovery and acquisition of non-hydrocarbon mineral deposits and was also responsible for the development of mines and related facilities necessary to mine those deposits. During the period 1960 through 1968 there were no activities of this department in the State of Wisconsin. (Tr. Vol. III, pp. 6-7).

The Land Management Department was responsible for administering and disposing of surplus properties that became surplus during the course of Petitioner's business. There were probably a few surplus service station sites in Wisconsin that were sold by this department, which dispositions were reported on its Wisconsin returns. (Tr. Vol. III, pp. 7-8).

Each of the operating departments had its own separate management responsible for the proper conduct of each department's operations, and consisted of a technical staff, an administrative staff and separate and distinct organizations which conducted operations in the field. Thus each functional department had a full management complement. (Tr. Vol. III, p. 9). Each functional department was a separate profit center which recorded the transactions involving expense and revenue so that a profit for that function could be determined. In addition, each department was a separate investment center, and records were maintained for each of these departments to reflect the investments in properties and fixed plant. The operation of those properties was such that the management of each could be held to a stewardship for their operation of those particular properties. Furthermore, each department was responsible for preparing and developing its specific goals and objectives. Each operating department had its own corporate accounting office which recorded and reported the cost analysis and the financial results of its operations. (Tr. Vol. III, pp. 10-13). Each department prepared its own capital budget

covering new investments for capital projects and programs, and each department also developed their own financial forecasts. Each department was responsible for its own employment and personnel administration including the selection, training, and termination of employees. In addition, each department had contracts with separate labor unions and each conducted its own bargaining with such labor unions. (Tr. Vol. III, pp. 16-17). Each functional department was also responsible for the inventories of materials and products under its jurisdiction. Each department maintained separate warehouses needed to provide storage for materials and products. Each department maintained its own accounts payable records. Credit and collection policies were established by each operating manager in each operating department. (Tr. Vol. III, p. 19). The responsibility for advertising and the development of sales promotion programs for Petitioner's petroleum products was the responsibility of the Marketing Department. Each region office in the field organization of the Marketing Department had a regional advertising manager who was responsible for implementing the advertising program and developing a sales promotion program that were appropriate for his particular geographic area. (Tr. Vol. III, pp. 20-25).

Petitioner did not have any crude oil or natural gas production in the State of Wisconsin, nor did it have any refineries located in the State of Wisconsin. (Exhibit 21;

Tr. Vol. III, pp. 27-29).

The State of Wisconsin was an expansion marketing area where Petitioner was making an entry into a new market. Petitioner was not widely known in Wisconsin, had limited facilities in the State and, therefore, was required to make additional investments over a long period of time in order to achieve the market position that would make Wisconsin acceptable as a mature market. During the 1960's the results of the marketing operations in Wisconsin were very unsatisfactory and resulted in only losses for those years. In 1970 Petitioner considered dis-investment in Wisconsin, however, before a viable disposition plan could be developed and implemented, the Federal Energy Administration instituted product allocation controls which prevented Petitioner from changing the nature of its operations in Wisconsin. Because of the uncertainty of continuing in Wisconsin, Petitioner's brand name was not changed from Enco to Exxon when that new brand name was adopted in early 1973. (Tr. Vol. III, pp. 30-33 and 35-36).

Petitioner's Exploration and Production Department competed with other companies who were also engaged in that function. In the same manner, the Refining Department would be competing with other companies engaged in refining activities. And finally, the Marketing Department would be competing with companies engaged in marketing activities. (Tr. Vol. III, pp. 39-43; Exhibit 22).

D. Utilization By Petitioner Of Third Party Transfer Prices.

It was the policy of Petitioner that the transfer prices or values for products and raw materials passing between the three major functional departments, i.e., Exploration and Production, Refining, and Marketing, should be based upon competitive wholesale market prices. Crude oil produced by Petitioner would be disposed of in the most economical market. As there was no mandatory requirement for crude oil produced by Petitioner to flow through Petitioner's refineries, such crude was either sold to third parties or transferred to a refinery depending upon which method would be the most economical. The refinery was not interested in the ownership of the crude or the source from which it was produced, but, rather, was concerned mainly with the quality and type of crude oil that was available. (Tr. Vol. III, pp. 11-13, Vol. IV, p. 11). Humble produced crude oil was always transferred from the Production Department to the Supply Department and then on to the Refining Department or to third parties on the basis of the posted field price for the field in which the crude was produced plus the applicable tariff for transportation. Neither the Exploration and Production Department nor the Refining Department had any say in the setting of the posted field price. (Tr. Vol. III, pp. 13-14, Vol. IV, pp. 11-12).

A posted field price was a published price which indicated

what a company was willing to pay for that crude oil it might buy from a particular field. The posted field price applied to all purchases of that particular crude, but it was not a commitment to buy; it was only a publication of the price at which crude oil would be purchased if it was in fact purchased. The Supply Department determined what Petitioner had to pay in order to buy the crude oil it needed. The posted field price was determined on the basis of what competitors were paying in the product market. The posted field prices were printed on bulletins by the company who was purchasing the crude oil. These bulletins were widely distributed to the media and interested parties and were available to all potential buyers and sellers. The posted field price was and still is a bona fide competitive price. All dispositions of crude oil by Petitioner were made at the posted field price whether the distribution was a transfer from the Exploration and Production Department into the Supply Department or a sale to third parties by the Supply Department. (Tr. Vol. IV, pp. 14-19; Exhibit 11-11, pp. 1-2).

The posted field price was the price utilized by Petitioner to pay royalty owners for the oil purchased from them pursuant to contract. The posted field price was also used by Petitioner to pay for oil purchased from any parties having working interests in any particular wells or leases. Whenever Petitioner sold crude oil to third parties the posted field price

was used as the sales price for this crude. The Supply Department in turn when it transferred crude to the Refining Department transferred it at the posted field price. (Tr. Vol. IV, pp. 19-22).

There were approximately 50 or 60 companies that issued postings for crude whenever they purchased crude oil. About 20 percent of all crude oil produced was produced by companies who only had production operations, and they sold their crude product at posted field prices. In addition, companies that only engaged in refinery operations purchased the crude they utilized at posted field prices. (Tr. Vol. IV, p. 21).

The posted field price was utilized for purposes of computing depletion for federal income tax purposes, and for computing the severence tax due to the producing states. The posted field price was also used by producing states to determine the income allocable to the wellhead for state income or franchise tax purposes. (Tr. Vol. V, pp. 11-12 and pp. 77-79).

The Natural Gas Department was a service organization to the Production Department and was responsible for the sale and purchase of natural gas for the Production Department. The Natural Gas Department was not a separate profit center and all of its plant and physical equipment were carried on the books of the Production Department. None of the natural gas went to the

Refining Department for product conversion. The only gas that went to the Refining Department was used for fuel consumption and amounted to approximately 4 percent of Petitioner's natural gas. All of the gas sold by Petitioner was sold in the states where it was produced. Petitioner was a net seller of gas. The Natural Gas Department did not have any activities in the State of Wisconsin. (Tr. Vol. IV, pp. 58-62). All gas sold by Petitioner to third parties was sold pursuant to a negotiated price pursuant to contract negotiations with the purchaser. All gas purchased by Petitioner was also purchased pursuant to negotiated contracts. In dealing with third parties on the purchase or sale of gas all terms were negotiated, such as price, quantity, quality, taxes and transportation costs. Any internal transfer of gas by Petitioner was based upon third party contracts in effect at the time of the transfer. (Tr. Vol. IV, pp. 61-65).

Petitioner was able to determine the prevailing contract prices for gas, as all purchasers of natural gas in Texas were required to file with the State Comptroller a report indicating volume of gas purchased, the name of the purchaser and the amount paid for the gas. In addition, all contracts for gas moving in interstate commerce had to be filed with the Federal Power Commission in Washington and these contracts as public documents were reviewed to determine contract prices for gas. It was the responsibility of the Natural Gas Department to determine what

the prevailing contract prices for gas were in the trade. All internal transfers of gas by Petitioner were based on prevailing third party contract prices. (Tr. Vol. IV, pp. 66-70).

Products transferred from Petitioner's Refining Department to its Marketing Department were transferred on the basis of wholesale market prices or some equivalent value usually based on prices quoted in Platt's Oilgram. Platt's Oilgram was a price service that primarily reported the wholesale market prices of various petroleum products at various points in the United States. These were prices of transactions between unrelated buyers and sellers and were prices at which products were actually changing hands in the trade. During the years 1965 through 1968 products transferred between the Refining Department and the Marketing Department were based on a formula tied to the price in Platt's Oilgram with a discount based upon a large third party sales contract with Standard Oil of Kentucky. (Tr. Vol. III, pp. 13-14, Vol. IV, pp. 79-83). If for any day there was a change in the Platt's price for a product there would be a corresponding change in the transfer price between the Refining Department and the Marketing Department. (Tr. Vol. IV, p. 88).

None of Petitioner's refined fuel products were sold in the State of Wisconsin during the 1965-1968 period. The products sold in Wisconsin were obtained pursuant to an exchange agreement with Pure Oil Company in Lemont, Illinois. When the Supply Department acquired products from Pure pursuant

to the exchange agreement and transferred them to the Marketing Department for use in Wisconsin, the transfer price for these products was based upon a discounted Platt's price plus the location differential which reflected the cost of moving the product from the Gulf Coast to Chicago plus any pipeline or terminal costs to get the product into Wisconsin. (Tr. Vol. IV, pp. 85-88).

For some of Petitioner's products, there was no readily available wholesale market value or price. In these cases, representatives of Petitioner's Marketing and Refining Departments, utilizing their knowledge of the market and the products, negotiated with each other on an arms length basis in an adversary position to determine the appropriate transfer value between these departments. Since posted field prices were used to value crude oil moving from Production to Refining, and since some products moving from Refining to Marketing had to be valued at a negotiated price, the measurement of revenue to the Production Department from its transfers of crude oil and gas to the Refining Department was more precise than the measurement of revenues to the Refining Department from its transfer of products to the Marketing Department. The basic objective of Petitioner's transfer pricing system was to provide a basis for valuing transfers which would approximate the same results as if one separate independent company had negotiated with another separate independent company. (Tr. Vol. III, pp. 14-18).

E. Reasons For Petitioner's Corporate Structure.

The various separate operating functions of Petitioner are incorporated under one corporate entity for a variety of reasons. A highly capital-intensive industry such as petroleum has high fixed operating costs relative to total operating costs so that profitability is very sensitive to full rates of capacity utilization. Where there is a high capital investment in refineries, the existence of an assured supply of raw materials and crude oil is important and an assured and stable outlet for products is also important. When these segments are under a single corporate entity it provides for assurance that the risk of disruptions in refining operations are minimized due to supply and demand imbalances that may from time to time occur. In addition, greater profit stability is maintained since non-parallel and non-mutual economic factors affecting one department may be offset by similar factors in another department. The operations of the Exploration and Production Department have a very high degree of risk that is much higher than any other type of industrial activity. When this operation is combined with operations with less risk it provides a diversification and gives protection against the risk factors inherent in the industry. In addition, putting the individual functional segments under a single corporate entity permits the utilization of corporate staff services of high quality with greater economy. (Tr. Vol. IV, pp. 43-46).

F. Accounting Practices In The Petroleum Industry And The Use Thereof By Petitioner.

During the 1965 through 1968 period, separate accounting records were maintained by Petitioner regarding Wisconsin's sales and expenses, and a record thereof was maintained in the Milwaukee District Office. Other than a minor reconciliation, the Auditor did not dispute the amount of sales reported nor the cost of goods sold on Petitioner's separate accounting returns for the years 1965 through 1968. The cost of goods reported was taken from Petitioner's books and records and was determined from the third party transfer prices described above. Most of the operating expenses deducted on the Wisconsin returns were items directly relating to the Wisconsin operation. However, the advertising expenses and the administrative expenses on the returns were allocated to Wisconsin on the basis of a sales realization method taking Wisconsin sales to the total regional sales. For the year 1965 even if 60 percent of the expenses allocated to Wisconsin were disregarded there still would have been a loss. In 1966 and 1967 if all the allocated expenses were disregarded there still would have been a loss. In 1968 if 85 percent of the expenses allocated to Wisconsin were disregarded there would still have been a loss. The expenses as reported on the Wisconsin returns for the years 1965 through 1968, including those allocated expenses, as accurately as possible reflected those expenses that were attributable to Wisconsin. (Tr. Vol. IV, pp. 119-123; Exhibit No. 27).

In the oil industry the posted field price was a figure at which crude oil was bought and sold in the market at various places. For accounting purposes that price was used as the measure of profitability and the sales value for crude oil. Multifunctional oil companies used posted field prices as a measure of value in transferring crude oil from the Exploration and Production Department into the Refining Department. Without exception, the oil companies used posted field prices in this manner. These companies also used a transfer price on natural gas which was related to existing third party contracts. (Tr. Vol. V, pp. 75-76).

For accounting purposes to correctly and fairly determine the profits of the exploration and production function, the use of posted field prices on transfers between exploration and production and refining gave a result equivalent to a third party sale price. For internal accounting purposes, the functional operating departments of a multifunctional oil company were generally treated as separate businesses. For transfers between refining functions and marketing functions of multifunctional oil companies, Platt's Oilgram was principally used to determine the transfer prices. Such a use provided an accounting result equivalent to a third party sale price which was arms length and fair and reasonable for accounting purposes. (Tr. Vol. V, pp. 84-89).

Petitioner consistently used posted field prices for recording the transfer of crude oil from the Exploration and Production Department to the Refining Department. Petitioner similarly used third party contract prices for the determination of the transfer price of natural gas to the Refining Department from the Exploration and Production Department. In addition, Petitioner used Platt's Oilgram or an equivalent calculation to determine the transfer price for products from the Refining Department to the Marketing Department. Petitioner's returns filed with the Wisconsin Department of Revenue for the years 1965 through 1968 fairly reflected the results of Petitioner's Wisconsin operations on a basis consistent with generally accepted principles of accounting consistently applied. (Tr. Vo. IV, pp. 130-131, Vol. V, pp. 10, 100-102).

Petitioner's internal accounting and transfer pricing procedures isolated and supported the identification of: (1) net income derived at the situs of production for the Exploration and Production Department; (2) net income derived at the point of operation for the Refining Department; (3) net income derived at the point of operation for the Marketing Department; and (4) net income derived from the State of Wisconsin separately. Each of Petitioner's Wisconsin returns for the years 1965 through 1968 on a separate accounting basis was valid in terms of proper internal accounting principles consistently applied. (Tr. Vol. V, pp. 103-105).

From an accounting standpoint, there was no relationship between the net income of the Exploration and Production Department and business done by Petitioner in the State of Wisconsin. Under generally accepted principles of accounting, such income was fully earned or derived by the Exploration and Production Department at the point where the oil and gas was available for disposition. Under generally accepted principles of accounting, the Refining and Marketing Departments did not serve to either increase or decrease the amount of Petitioner's production income. (Tr. Vol. V, pp. 5-6, 95 and 106). The application by the State of Wisconsin of its apportionment formula against Petitioner in effect produced Wisconsin taxable income by subjecting Petitioner's net income from its Exploration and Production Department and Refining Department to tax in Wisconsin (Tr. Vol. V, pp. 106 and 110-111).

The apportionment formula as applied by the Respondent did not achieve a meaningful, reliable or reasonable result for the following reasons. The Wisconsin income that was taxed under the formula had a much higher percentage of each sales dollar than did the total income of Petitioner's Marketing Department to total sales. There was a distortion between the comparison of Wisconsin factor attributes of each function to the percent of income produced by each function. There was a distortion in the comparison of percent of income from the total Marketing Department with the percent of net income from

the Wisconsin marketing operations. For these reasons Wisconsin has reached out to tax income which was not appropriately related to operations in the State of Wisconsin. (Tr. Vol. V, pp. 111-113; Exhibit No. 29 and Exhibit No. 30).

G. Economics Of The Petroleum Industry And Of Petitioner.

There are three ingredients that must be present in order for an economic unit to be considered unitary. The first is the essentiality of each component part of the unit to the viability of the unit. The second is the presence of a firm and clean price for a product. The third is the presence of identifiable costs for the operation of that unit. An integrated company is one which brings together unitary groups that could survive independently but which are brought together for purposes of providing greater economics of scale. In an economic sense, when something is referred to as being an integral part of a unit, that something is an operation or a process which is indispensable for the functioning of that unit. First it must be found that a business is unitary in order to identify that which is an integral part of that unitary business. (Tr. Vol. VI, pp. 9-15).

The fact that a vertically integrated company composed of separate unitary businesses has a common name and a common board of directors, common officers and common staff departments such as planning, secretary, treasurer,

controller, tax, law, public relations, government relations, and employee relations, would not make that vertically integrated corporation one unitary business. The existence of these staff services do not make the separate unitary businesses in a single corporate shell into a single unitary business. Nor would it make such an integrated company unitary if there was brand identity, quality control protection, or operations across state lines. (Tr. Vol. VI, pp. 16-19).

During the years 1965-1968 Humble was an integrated company, but as such it was not a unitary business. The functional operations of Petitioner's Exploration and Production Department, Refining Department and Marketing Department were carried on as three separate unitary businesses. The Wisconsin marketing operations of Petitioner were not an integral part of Petitioner's Exploration and Production Department. There was no economic dependence between the Wisconsin marketing operation and the Exploration and Production Department. The Wisconsin marketing operations could be severed without affecting the economic viability of the Exploration and Production Department. During the period 1965 through 1968 the Wisconsin marketing operations were not an integral part of Petitioner's Refining Department. There was no economic dependence between the Wisconsin marketing operations and the Refining Department as the Refining Department was a unitary business that could have functioned with or

without the Wisconsin marketing operation. The Wisconsin marketing operation could have been feasibly and economically severed without affecting Petitioner's Refining Department operations. If the Wisconsin marketing operations could be separated on an economically feasible basis, those operations would not be an integral part of Petitioner's Marketing Department operations. (Tr. Vol. III, p. 37, Vol. VI, pp. 30-34).

H. Nature Of The Two Audits Of Petitioner By Respondent.

Mr. Kaspar, the Auditor for Respondent who conducted the first audit of Petitioner in 1966, had no special training in oil and gas accounting. (Tr. Vol. I, p. 154; Exhibit 8, pp. 9-11). Mr. Kaspar utilized the work papers from a previous Continental Oil Company audit as a pattern for his audit of the Petitioner. (Tr. Vol. I, p. 4). Mr. Kaspar was given verbal instructions in the Madison office to go to Houston and do the audit of Petitioner to determine if they were filed on a correct basis and to recompute the income if they were filed on an incorrect basis. Mr. Kaspar was instructed to follow the guidelines set forth in the Longhorn paper (Exhibit 12-B). Mr. Kaspar did not follow the recommended procedures contained in the Longhorn paper for the audit of Petitioner. (Exhibit 8, pp. 50-51). Mr. Kaspar had no basis for challenging the amount of sales reported by Petitioner in its

returns to the State of Wisconsin for the years in question. Nor did he have any basis to challenge the cost of sales figures used in the returns. (Tr. Vol. 1, pp. 14-15). Mr. Kaspar also indicated that he was willing to accept the operating and overhead expenses, but he had some questions about allocated area expenses on the Wisconsin returns. (Tr. Vol. I, pp. 14-15). Mr. Kaspar had no knowledge of the use of posted field prices: for valuing interests of royalty owners, for valuing working interests, for use by the Internal Revenue Service to compute depletion deductions or for severance tax purposes by the various producing states. Mr. Kaspar did accept the internal integrity of the Exploration and Production Department's net income by using that figure as a base figure in his audit. Mr. Kaspar did not verify the integrity of the transfer prices as third party prices in their use between the Exploration and Production Department and the Refining Department and between the Refining Department and the Marketing Department. Nor was Mr. Kaspar familiar with Platt's Oilgram. (Tr. Vol. II, pp. 19-26).

Mr. Kaspar believed that Petitioner was unitary due to the flow of its product. His theory was that this product was produced by Petitioner, refined by Petitioner, marketed by Petitioner, and found its way into Wisconsin. (Exhibit 8, p. 21). However, Mr. Kaspar understood that the fuel oil and gasoline sold by Petitioner in Wisconsin was not produced

by Petitioner, but was obtained pursuant to an exchange agreement. Mr. Kaspar had been advised by Petitioner that about ten percent of all Wisconsin sales were of packaged products, such as industrial oils and greases, that were produced by Petitioner. (Exhibit 8, p. 44).

The first audit of Petitioner was referred to Mr. Garno, supervisor of the Corporation Field Audit Unit of Respondent, in approximately 1963 by an office auditor named Don Weber. Mr. Garno then assigned the field audit to Mr. Kaspar in 1966. (Tr. Vol. II, pp. 98-100 and 107). Mr. Garno told Mr. Kaspar that Petitioner was a candidate to be put on apportionment. Material prepared by Mr. Weber indicated that there was "a bundle" of potential tax for Wisconsin on an apportionment formula basis. (Tr. Vol. II, pp. 108-109, Exhibit 11-4 (38)). The field audit assignment of Petitioner was made by Mr. Garno with the preconceived possibility that Petitioner could be changed to apportionment resulting in potential revenue being obtained by Respondent. (Tr. Vol. II, pp. 114-115). In a letter to Mr. Garno from Mr. Weber, dated July 16, 1963, Mr. Weber stated in part: "It looks like we would make a bundle of tax if we switched Humble to the statutory formula method of apportionment. It also appears that Humble is bleeding the Pate Division through marketing and administrative expenses. Both 1961 and 1962 of Humble have good total company profits." And again in a letter to Mr. Garno from Mr. Weber dated September 19, 1964

Mr. Garno states: "Humble looks like an excellent prospect for changing from the separate accounting method to apportionment." (Tr. Vol II, pp. 116-118; Exhibit 11-4 (38) and (40)). It was these memos that resulted in the first field audit of Petitioner. The second audit of Petitioner in 1969 was assigned by Mr. Garno to Mr. Sheridan. Mr. Garno did not give Mr. Sheridan any instructions regarding apportionment or how to determine whether or not Petitioner was a unitary business. Mr. Garno suggested, after the assessment was made and the appeal was begun, that the Department might want to obtain more data regarding Petitioner's status as a unitary business. This suggestion was made in late 1971, however, neither Mr. Sheridan nor anyone else went back to Petitioner to obtain any more information. This was done because Mr. Garno felt that the Department did not have "an awful lot of facts for the current audit period." Mr. Garno did not believe that Mr. Sheridan made any serious inquiry into the unitary concept, nor did he follow the Longhorn paper guidelines which Respondent recommended be followed to determine whether a company is unitary. (Tr. Vol. II, pp. 119-127). The principal fact, in the opinion of Mr. Garno, that made Petitioner a unitary business was that Petitioner's Wisconsin operations as constituted could not function without the intervention of activities by employees of Petitioner outside of Wisconsin. (Tr. Vol. II, pp. 128-129).

Mr. Garno did not have any oil and gas accounting training or experience, and he had never conducted any audits of oil companies. (Tr. Vol. II, p. 96).

Mr. Garno did not recall reviewing Mr. Kaspar's work papers after submission of his audit report. (Tr. Vol. II, p. 119). Mr. Garno had no personal knowledge of any of Petitioner's activities other than that which was reflected on their returns or on information obtained by the auditors. (Tr. Vol. II, p. 128).

Mr. Sheridan was the Auditor for Respondent on the second audit of Petitioner covering the years 1965-1968. This was Mr. Sheridan's first audit of an oil company. Prior to this audit he had had no oil and gas accounting training or experience. (Tr. Vol. 1, p. 43; Exhibit 7, p. 9). Mr. Sheridan was assigned the audit by his supervisor, Mr. Garno, some time in 1970. (Tr. Vol. 1, p. 43; Exhibit 7, p. 28). Mr. Sheridan did not recall being given any instructions for the audit of Petitioner; however, he was given the work papers and audit report (Exhibit 11-3) from Mr. Kaspar's audit of Petitioner. Mr. Sheridan used Mr. Kaspar's work papers and report as his model for his audit. (Exhibit No. 7, pp. 31-33). Mr. Sheridan had not had any specific schooling or training in how to determine whether or not a business was unitary. He only had practical experience as an auditor with Respondent. (Tr. Vol. 1, p. 66; Exhibit 7, p. 36). Mr. Sheridan stated

that a unitary company is "a company which does a variety of activities to make money." (Exhibit 7, p. 38). Mr. Sheridan stated that according to the Department Manual (Exhibit No. 10A) and the statute a factual determination must be made as to whether a business is a unitary business. (Tr. Vol. 1, p. 68). However, Mr. Sheridan was not able to locate in his work papers (Exhibits 11-5 and 11-6) any material which would indicate that he made an investigation of Petitioner's operations on which to base a factual determination that it was unitary. (Tr. Vol. 1, pp. 68-101). Mr. Sheridan did not ask the questions of Petitioner that are set forth in the Longhorn paper (Exhibit No. 12-B) which is a guideline available to the auditors. (Tr. Vol. 1, pp. 109-110). Mr. Sheridan indicated that as the prior audit established the fact that Petitioner was unitary he did not question the unitariness of Petitioner. (Exhibit 7, pp. 43-44). Mr. Sheridan stated: "The way the products flow through the company, to me that is unitary." (Exhibit 7, p. 44).

Mr. Sheridan did not know how posted field prices were determined, although he knew that Petitioner transferred products between departments at posted field prices. (Exhibit 7, pp. 82-83). Mr. Sheridan was not familiar with Platt's Oilgram nor was he familiar with the use of Platt's in transferring products from Petitioner's Refining Department to its Marketing Department. (Exhibit 7, p. 86).

Both Mr. Leidiger and Mr. Hoel stated that it was Respondent's position that if none of an oil company's produced crude oil is transferred to its refineries there would be no flow of product to make that a unitary operation between exploration and production on the one hand and refining on the other. (Exhibit 9, pp. 39-40; Exhibit 10, p. 14).

Mr. Leidiger reviewed Mr. Kaspar's audit and signed the assessment letter (Exhibit 2) for the first audit of Petitioner. (Tr. Vol. II, p. 86).

Mr. Leidiger had audited between 8 to 10 oil companies from the late 1950's through 1964. He participated in several staff conferences during the Kaspar audit. He had no other oil and gas company experience, and he had no formal oil and gas accounting training. (Tr. Vol. II, pp. 74-76).

Mr. Leidiger had no knowledge as to the internal operations of Petitioner or as to how Petitioner utilized posted field prices. Mr. Leidiger was not familiar with Platt's Oilgram. Nor was he familiar with Petitioner's transfer pricing policy. (Tr. Vol. II, pp. 84-87).

Mr. Hoel had no oil and gas accounting experience or training and had never conducted any oil company audits. In his supervisory capacity he had signed about 10 to 12 assessment letters for oil companies, and had reviewed the audit reports attached to these letters, but he had never made any changes in these audits. (Tr. Vol. II, pp. 38-39).

Mr. Hoel reviewed Mr. Sheridan's audit report and signed the assessment letter (Exhibit 1) to Petitioner for the second audit. Mr. Hoel had no direct or independent knowledge of posted field prices, Platt's Oilgram or Petitioner's transfer pricing policy. (Tr. Vol. II, pp. 69-70).

II. INTRODUCTORY STATEMENT

The initial audit of Petitioner by Respondent for the years 1960 through 1964 was begun with the preconceived conception on the part of Respondent that Petitioner was a unitary business. Consequently, a thorough examination of Petitioner's business was not made to support a factual determination that Petitioner was unitary. Respondent did not audit Petitioner's separate accounting returns, but rather conducted the audit as if Petitioner was a unitary business. As a result of this audit Petitioner was switched by Respondent to an apportionment method of computing the income tax due to the State of Wisconsin.

With the preconceived conception that Petitioner was unitary the second audit of Petitioner for the years 1965 through 1968 was again conducted with no attempt to make a factual determination as to unitary nor to verify the correctness of the separate accounting returns. This second audit again changed Petitioner to an apportionment method for determining its income tax liability to the State of Wisconsin.

As Respondent did not make the required statutory factual determinations that Petitioner was a unitary business, and that the Wisconsin operation was an integral part of that business,

the switching of Petitioner to the apportionment formula method of reporting was illegal, arbitrary and capricious. Petitioner's separate accounting returns reasonably reflected the operations of Petitioner in the State of Wisconsin, and these returns must be accepted as correct. Therefore, Petitioner has no tax liability to the State of Wisconsin.

If this Commission finds that Petitioner's separate accounting returns did not properly reflect the income taxable in Wisconsin, and that the apportionment formula must be utilized, then Petitioner contends that the formula used by Respondent was improper and illegal and that, in any event, all income from Exploration and Production should have been allocated and excluded from apportionment.

As described in the hearing in this cause, Petitioner's three operating functional departments, Exploration and Production, Refining and Marketing, were organized and run as separate segments of the total corporate enterprise. Due to the nature of this structure, each of these three operating departments was in fact a unitary business. None of the departments was an integral part of any other department. Neither the Exploration and Production Department nor the Refining Department had any operations or business in the State of Wisconsin. As these two functions have no nexus to the State of Wisconsin, the income derived by each of these functions cannot be included in the Wisconsin apportionment

they would have been discarded as being illegal under Sections 71.07(1) and (2).

Nor can Respondent find relief under the decisions in other jurisdictions. Since 1920 there has been a parade of cases which held, depending on which side of the coin came up, either that oil and gas production income was taxable in the producing states, or, in the converse, that such income could not be taxed in non-producing states: Shaffer v. Carter, 252 U.S. 37, 40 S. Ct. 221 (1920); Fisher v. Standard Oil Co., 12 F.2d 744 (8th Cir. 1926); Standard Oil Co. v. Thoresen, 29 F.2d 708 (8th Cir. 1928); Magnolia Petroleum Co. v. Oklahoma Tax Commission, 190 Okla. 172, 121 P.2d 1008 (1942); Texas Company v. Cooper, 236 La. 380, 107 So. 2d 676 (1959); Skelly Oil Co. v. Commissioner of Taxation, 269 Minn. 351, 131 N.W.2d 632 (1964); Webb Resources v. Mc Coy, 194 Kan. 758, 401 P.2d 879 (1965); Tenneco, Inc. v. Barr, 224 So. 2d 208 (Miss. 1969). And of utmost significance is the fact that the above Courts, in reaching their unanimous decisions, either ignored or specifically thrust aside all claims of "unitary" as well as all claims regarding product flow from production to refining to marketing (or any other disposition of product) as being irrelevant to the question of which states can or cannot tax situs income.

Stated simply, all exits are closed to Wisconsin's attempt to tax any portion of Petitioner's production income.

and 1965-1968 audits in a completely offhand and disinterested manner insofar as Petitioner's functional operations in general and its Wisconsin operations in particular were concerned. In context, then, it can only be concluded that the "definitions" and "concepts" quoted in Appendix II are post-decision, justification definitions, not pre-decision, analytical definitions and, hence, are completely suspect as to factual, economic and legal validity.

(2) The Court Decisions In No Way Support Respondent's Conclusions:

Heading the list of applicable decisions are three oil and gas cases: Standard Oil Co. v. Wisconsin Tax Commission, supra; Skelly Oil Co. v. Commissioner of Taxation, supra; Tenneco, Inc. v. Barr, supra. The Standard Oil Co. case has been freely cited and quoted above, so it only needs repeating here that the Respondent's arguments in that case, while not using the terms "unitary" and "integral", were precisely the same as those used here in an attempt to support "unitary" and "integral". And for many of the reasons advanced by the Petitioner here, the Wisconsin Supreme Court rejected apportionment and approved separate accounting.

The Skelly case presents an even closer parallel to Petitioner's position in this case and held for the taxpayer. The Minnesota Supreme Court concluded that the exploration and

production, refining and marketing functions of the taxpayer were operated as separate businesses, with this conclusion not being modified by the existence of four staff or administrative service departments - accounting, purchasing, law and secretary-treasury, and with that conclusion being bolstered by the existence of independents at each functional level. Further, it was concluded that because posted field prices were competitively established, were employed for federal depletion, severance tax, production states income tax and royalty payment purposes, and for the prices at which the taxpayer bought and sold crude oil, they constituted a bona fide base for internal transfer pricing from production to refining. It was also observed that exchange agreements were of no benefit to production, only to refining and marketing, so they had no bearing on the separate businesses concept. Adding this all together, the Court held that only marketing income was exposed to taxation, this being the only function carried on in Minnesota, and that the "unitary" concept was inapplicable.

In Tenneco, the taxpayer operated a gas transmission system, part of which was situated in Mississippi, and a gas exploration and production function carried on outside Mississippi. The former was operated at a profit and the latter at a loss, so the taxpayer sought total apportionment on

the unitary theory, which the Tax Commission opposed (the duplicate of the situation in the Clark Oil case now pending before this Commission). The Court held the transmission business alone to be unitary and subject to apportionment (typical of almost all transportation and communication cases), but that the gas exploration and production operations were not unitary with or an integral part of the transmission operations, and, hence, that separate accounting applied to those functions.

Reference should also be made to the oil and gas cases cited supra under Caption B(1): Shaffer v. Carter; Fisher v. Standard Oil Co.; Standard Oil Co. v. Thoresen; Magnolia Petroleum Co. v. Oklahoma Tax Commission; Texas Company v. Cooper; Webb Resources v. Mc Coy. Separate accounting, or its equivalent, was required in all cases, and this regardless of whether production or marketing income was involved, regardless of whether an individual or a corporation was involved, regardless of whether the operation was multistate or single state, and regardless of whether the operation was multifunctional or a single function. The message is sharp and clear. Functional income in the oil and gas industry can and must be segregated by functions and by states, and this segregation is predicated on derived income, unrealized or realized, not

simply on realized income from ultimate sales to third parties. (In passing it might be noted that several of the above decisions cited Standard Oil Co. v. Wisconsin Tax Commission, supra, with approval and as being authoritative)

To this oil and gas pattern of decisions should be added Hans Rees' Sons, Inc. v. State of North Carolina, 283 U.S. 123, 518 S. Ct. 385 (1931), decided after the Wisconsin Standard Oil case but cited as authority in the Skelly case. Because the taxpayer in that case was able to establish three different functional sources of income and could isolate the functional source in North Carolina, the use of apportionment was denied. Particularly pertinent to Respondent's position here is a controlling comment of the Court (283 U.S. at 133, 518 S. Ct. at 389):

> "But the fact that the corporate enterprise is a unitary one, in the sense that the ultimate gain is derived from the entire business, does not mean that for the purpose of taxation the activities which are conducted in different jurisdictions are to be regarded as 'component parts of a single unit' so that the entire net income may be taxed in one state regardless of the extent to which it may be derived from the conduct of the enterprise in another state." (Emphasis supplied)

This is the point to Petitioner's argument under Caption B(1) above.

Nor do other so-called "unitary" decisions detract in any way from those key decisions cited above: Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113, 41 S. Ct. 45 (1920); Bass, Ratcliff & Gretlon, Limited v. State Tax Commission, 266 U.S. 271, 45 S. Ct. 82 (1924); Maxwell, Comr. v. Kent-Coffey Manufacturing Company, 204 N.C. 365, 168 S.E. 397 (1933), aff'd, 291 U.S. 642, 54 S. Ct. 437 (1934); Butler Bros. v. McColgan, 315 U.S. 501, 62 S. Ct. 701 (1942); Celon Company v. Department of Taxation, supra; Interstate Finance Corporation v. Department of Taxation, supra; Superior Oil Co. v. Franchise Tax Bd., 60 Cal.2d 406, 386 P.2d 33 (1963); Honolulu Oil Corp. v. Franchise Tax Bd. 60 Cal.2d 417, 386 P.2d 40 (1963). In every instance, those cases dealt with single, horizontal business operations: Underwood in manufacturing and related selling; Bass in manufacturing and related selling; Maxwell in manufacturing and related selling; Butler Bros. in mail-order selling and distribution; Celon in manufacturing and related selling; Interstate in financing; and Superior and Honolulu in crude oil production only. Appropriately, then, the Wisconsin Supreme Court in Standard Oil rejected Underwood as not being applicable and the Minnesota Supreme Court in Skelly rejected Underwood, Bass, Butler Bros., Superior and Honolulu as not being applicable.

Perhaps equally to the point is the fact that the decisions in Underwood, Bass, Maxwell, Butler Bros. and Interstate are studded with judicial observations to the effect that the taxpayers had not put in a case challenging the validity of unitary or apportionment, leaving the courts in the position of having to rule simply on the record before them. The Court in holding for the taxpayer in Hans Rees particularly stressed this deficiency factor in Underwood and Bass.

To this some collateral comments might be added. In Celon, because of out-of-state losses, Respondent opposed the apportionment method whereas the taxpayer pleaded for it and won on the unitariness of its manufacturing and related selling operations. And possibly to Respondent's embarrassment, its own witness, Keesling, in addition to admitting that his dependency and contributory theory, which was quoted in the Wisconsin Interstate case, has since been overruled (see above), also admitted that the "unitary" test known as "the three-unities definition, unity of ownership, unity of use, and unity of operation" applied in Butler Bros., which Keesling claims credit for initiating, is no longer a valid test (Tr. Vol. VII, pp. 5, 6, 11).

The composite result of the foregoing is simply that there is no judicial cover to which Respondent can turn in support of its apportionment action in this case once the Petitioner establishes the fact that its various functional

operations are carried on as separate segments within its total corporate enterprise.

(3) Petitioner Conducts and Accounts for Its Operational Functions as Separate Segments of Its Total Corporate Enterprise:

A test of utter factual simplicity should be persuasive that Petitioner's Wisconsin marketing business is not an integral part of anything. Pate Oil Company, prior to acquisition in 1956, was a Wisconsin marketing independent. It was not an integral part of anything. For years prior to Pate's merger into the Petitioner, the Petitioner had been engaged in Exploration and Production, Refining and Marketing functions, but the Pate business made no impact on any of those functions except to produce losses for the previously established Marketing function. By 1970, Petitioner was prepared to dis-invest the Wisconsin marketing unit, but was prevented from so doing by government regulations. There is no hint in the record that a decision to dis-invest would be coupled even remotely with any adjustments in Exploration and Production, Refining or Marketing other than to permit the Marketing operation to breathe a sigh of relief. How less "integral" and how less "unitary" could an operation be?

Not content, however, with such persuasive simplicities, the testimony of Petitioner's internal and external expert witnesses has been converged to establish the uncontroverted

fact that its operational functions were conducted and were accounted for as separate segments of its total enterprise. The roster of witnesses speaks for itself: Oral L. Luper, Senior Vice President and member of the Management Committee; John G. Yaeger, General Manager, Supply Department; John Carter, General Manager, Natural Gas Department; Donald A. Campbell, Staff Commerce Advisor, Supply Department; Robert D. Koonce, Senior Tax Specialist; E. L. Wehner, Partner, Arthur Andersen & Co.; and Ezra Solomon, Dean Witter Professor of Finance, Stanford University. Their combined testimony has been condensed and organized under Captions C through G of the Statement of Facts, which will not be repeated here, but salient features will be emphasized in terms of the legal aspects of this case.

The aggregate evidence fits snugly into all the requirements of the _Standard Oil_, _Skelly_, _Tenneco_ and _Hans Rees_ decisions, _supra_. That same evidence clearly distinguishes Petitioner's multifunctional, separately segmented operations from the single, horizontal functional operations found in the _Underwood_, _Bass_, _Maxwell_, _Butler Bros._, _Celon_, _Interstate_, _Superior_ and _Honolulu_ decisions, _supra_. And, again, that same evidence overwhelmingly and affirmatively makes completely clear the fact of Respondent's taxation overreach, thereby avoiding the deficiencies in the taxpayers' evidentiary records

about which the courts complained and which controlled the results in the Underwood, Bass, Maxwell, Butler Bros. and Interstate decisions, supra.

In a true economic sense, as analyzed by Solomon, Petitioner's independent expert economist, the functions of Petitioner's Exploration and Production, Refining and Marketing departments were conducted and accounted for as separate segments of a total enterprise, each of which unto itself might be called "unitary", but the Wisconsin marketing operations can hardly be deemed to be an intergral part of Petitioner's total Marketing function. Through integration within one corporate shell, Petitioner gained the economic advantages of combining these various unitary functions into one corporate enterprise, but in so doing the total business of that corporate enterprise was not thereby transformed, for state taxation purposes, into a total unitary business nor, for such state taxation purposes, was each function thereby transformed into an integral part of that total corporation enterprise. By any economic test, "integrate" does not equate with the state taxation concepts of either "unitary" or "integral", and, by the same token, the Respondent cannot by administrative fiat transform "corporate enterprise" and "unitary" into synonomous, economic terms for state taxation purposes.

Consistent with the foregoing, Petitioner's operating

functions were managed on a separate basis -- separate profit centers, separate investment centers, separate management groups, etc., etc. They were accounted for separately by internal accounting practices consistent with accepted industry methods and procedures. This internal accounting pattern, based as it was on internal transfer prices which, in turn, were predicated on posted field prices for crude oil, field prices for gas and Platt's Oilgrams, third-party contract prices or arms length negotiated prices for refined products, produced derived income for each operating function with complete integrity (the Section 71.07 requirement), which Respondent neither tested nor challenged. In fact, Petitioner's derived income figures for crude oil and gas were accepted for federal depletion computations, severance tax payments and royalty and working interest payments, all third-party tests, and were accepted without question by Respondent as the basic figures in constructing its abortive, hybrid apportionment formula.

To all of this there should be added something of a tangential commentary. It would appear that the "flow of product" through all functions is Respondent's central theme for its "unitary" and "integral" tests in this case, but that theme is neither sound factually nor sound as an economic concept. The Petitioner produced, bought and sold crude oil, with all purchases and sales being handled by the Supply

Department. It was also the function of the Supply Department to provide Petitioner's refineries with crude. This it did indiscriminately out of available crude, produced or purchased, having regard only for quality, price and transportation costs, and with the Refining Department having no knowledge of original production sources, and caring less. So, as a matter of fact, the chain of the "flow of product" theory was severed at the threshold between Production and Refining.

As for refined products, the "flow of product" theory is equally unsound. Again, insofar as fluid products were concerned, Marketing was more interested in the cost, quality, and availability of those products than the ownership of the refineries from which they came. Bearing witness to this is the case of Petitioner's marketing in Wisconsin. Only 10% or less of sales in Wisconsin were tied to Petitioner's products, and they were all packaged products. The other 90% plus of sales, reflecting fluid products (gasoline, etc.), were tied to an exchange agreement, with those products being imported into Wisconsin from the Lemont, Illinois refinery of Pure Oil. None of the crude going into that Lemont refinery was produced by Petitioner, so, as a matter of fact, the Wisconsin refined, fluid products stand divorced from Petitioner's Exploration and Production and Refining operating functions.

As an economic concept, the "flow of product" theory likewise stands indicted. The simplicity of the Pate Oil Company pre-merger situation again supplies a pungent example. It was an independent marketer only, it depended completely on a "flow of product" from out-of-state refineries, but it filed on a separate accounting basis without the Respondent making the obviously absurd suggestion that Pate should somehow include some of the income from the production and refining activities of those outside suppliers in the Pate tax returns. And to add to the enigmatic posture of the Respondent, reference need only be made to the Wisconsin decision in Interstate, supra. The taxpayer had both branches and wholly owned subsidiaries in Wisconsin, all engaged in the same business and all parts of the same pattern, but Respondent had only included the branches, not the subsidiaries, in the apportionment package. Arguing that if "unitary" and "integral" tests were valid, the taxpayer insisted that the subsidiaries should likewise be included in the package. This the Supreme Court denied, ruling, in accordance with Respondent's urging, that consolidated tax returns were not permitted by law and that the 1949 amendment, despite its new "unitary" and "integral" language, did not change this.

Cut either way, it is Respondent's untenable legal and economic theory that, for state taxation purposes, if a "flow" is detected or, as in this case, presumed within a single corporate shell, "unitary" and "integral" follow, and so does taxation of the total "flow". But if the alleged "flow" crosses the lines of two or more corporate shells, even though parts of a single enterprise, that "flow" disappears and so do "unitary", "integral" and the right to tax on a total "flow" basis. As an oblique query, one is entitled to wonder why, if the crossing of artificial corporate lines dissipates "flow", "unitary", "integral" and the right to tax, the crossing of artificial state lines fails to cause that same dissipation, yet one of Respondent's arguments for "unitary" and "integral" in this case is the very fact that the "flow" does cross those artificial state lines (Appendix II).

But, whatever, this whole concept of "flow" being a legitimate test of "unitary" and, hence, leading automatically to the application of the apportionment method, is nakedly exposed for what it is not worth in the Kansas City Star case, supra. There, the total product "flowed" out of Wisconsin into the Missouri operation, but the Respondent opted for separate accounting and ficticious "theoretical transfer prices". In contrast, the presumed "flow" in this case took

place entirely outside Wisconsin, yet the Respondent insists that apportionment is mandatory as to the "flow".

Returning to the main stream, by management conduct, by accounting methods and procedures and by the tests of economic concepts, Petitioner conducts and accounts for its functional operations as separate segments of its total corporate enterprise. Respondent, being faced with the record on this source, cannot parlay the statutory terminology of Section 71.07(2) into something else.

(4) Conclusions as to This Caption C:

On both the situs basis of Caption B above and the separate functional basis of this Caption C, it is doubly clear that Respondent cannot reach for any derived income of the Exploration and Production operating function of the Petitioner. On the separate functional operations basis of this Caption C, it is likewise clear that Respondent cannot reach for any derived income of the Refining operating function of the Petitioner or of the non-Wisconsin derived income of the Marketing operating function of the Petitioner. Separate accounting for Petitioner's marketing operations in Wisconsin remains the only valid basis for taxation, but, at the very least, Petitioner is entitled to have the income from its Exploration and Production function totally excluded from the reach of Respondent.

D. RESPONDENT'S USE OF ITS HYBRID APPORTIONMENT FORMULA HAS PRODUCED AN UNREASONABLE AND ARBITRARY TAX WITH RESPECT TO PETITIONER'S WISCONSIN BUSINESS

In the discussion under Caption C(2) above of many of those cases which permitted the use of apportionment formulae, it was stressed that in each instance the protesting taxpayer had either (a) failed to show that its various operations were carried on and accounted for as separate functions, or (b) failed to show that the amount of income subjected to taxation was clearly erroneous, or both. The arguments under Captions B and C completely fulfilled the first requirement in this case and the presentation under this Caption D deals with the second.

Five key exhibits and the accompanying testimony of Koonce, the Petitioner's Senior Tax Specialist, and of Wehner, the Petitioner's independent tax accounting expert, spell out the magnitude of the overreach in this case (Exhibits 21, 27, 28, 29, 30; Tr. Vol. IV, pp. 119-147a, Vol. V, pp. 2-20, 101-115). And, in the converse, those same exhibits and that same testimony irrevocably establish the accuracy and integrity of Petitioner's separate accounting returns for the years in issue, or, in the alternative, the right of Petitioner in any event to exclude Exploration and Production income from Wisconsin taxation.

(1) Exhibit 28:

Schedule A of Exhibit 28 first contrasts the results of Petitioner's separate accounting for the four years in question with the results obtained by Respondent through the device of its hybrid apportionment formula. The spread in tax is the difference between zero (per Petitioner) and $316,471 (per Respondent), and the spread in taxable income is $8,459,104 (the total of a $3,926,949 loss per Petitioner and a $4,532,155 alleged profit per Respondent).

But even when any of three other objective tests are employed, the results are as dramatically at odds with those conjured up by Respondent. If apportionment of Petitioner's Marketing function alone is tested, the spread in taxable income is still a massive $2,445,548 and the tax spread is a substantial $171,187. If apportionment of Petitioner's Marketing and Refining functions together is tested, the income spread is $2,672,765 and the tax spread is $187,093. And if total situs income is first allocated and the remaining income apportioned, the income spread is $1,957,629 and the tax spread is $136,254.

Importantly, these are not fictitious spreads. The three comparative tests were predicated on the same base or starting figures used by Respondent; in all instances those figures were adjusted to a Wisconsin basis as required by statute; and those three tests represent the only apportionment alternatives permitted by Section 71.07(2).

Thus, the overreach by Respondent stands in stark relief for all to see, and it runs in the millions.

(2) Exhibit 29:

This Exhibit 29 demonstrates that Respondent has endeavored to work a marketing miracle in Wisconsin, something Petitioner had been so unsuccessful in doing that it had considered dis-investment of its Wisconsin operations (see above). The message sought to be conveyed by Respondent is that whereas over the four years at issue Petitioner enjoyed only a 3.2% average yield per sales dollar nationally in its Marketing function, the yield in Wisconsin was 7.5%, or approximately 2-1/2 times greater. There is nothing in the record which even remotely justifies such an assumption or premise by Respondent, inasmuch as it ignores the fact that Wisconsin was an expansion marketing area rather than a mature marketing area where a higher return is normally experienced. And the Kansas City Star decision, supra, makes clear that the Respondent lacks the power thus, gratuitously, to bestow on Petitioner nonexistent, taxable income in Wisconsin.

(3) Exhibit 30:

This Exhibit 30 was extracted in whole from the decision in Skelly Oil Co. v. Commissioner of Taxation, supra, where it constituted a key point in the decision for the taxpayer. In short substance it tells the overreach story of what happens when a state in which the only operation is

marketing includes in its apportionment formula attributes from out-of-state functions.

As shown here, the average Marketing attributes amounted to 22.3% of the total attributes involved, whereas Marketing accounted for only an average 14.3% of Petitioner's total net income. Yet, by the fact that attributes from non-Wisconsin functions were encompassed in the formula (Exploration and Production at a 22.6% average and Refining at an average of 51.7%), Respondent has helped itself to a share of the 74.4% of income produced by Exploration and Production and to the 7.7% produced by Refining.

As concluded in <u>Skelly</u>, such overreach results are indefensible.

(4) <u>Exhibit 27</u>:

As noted under Caption C above, Respondent made only a cursory check of Petitioner's Wisconsin sales and cost of sales figures as reported in its separate accounting returns, but no check was made of Wisconsin expenses, all this because of the policy of Respondent not to check separate accounting returns once it was "concluded" that the taxpayer's business was unitary. It was conceded, however, that Respondent had no basis for challenging the integrity of Petitioner's separate accounting returns, <u>except</u> <u>possibly</u> for the allocation of certain expenses, admitting in the next breath that those which were direct and those which were allocated were not known to Respondent, nor

was there knowledge as to the method of allocation for those expenses which were allocated.

To demonstrate the integrity of its separate accounting returns, Petitioner prepared Exhibit 27 as a means of penetrating this foggy area of Respondent's audit. The allocated expense items are specifically identified as to character and amount. The end result of the Exhibit is that if 60% of such items for 1965 were eliminated, 100% for 1966 and 1967 were eliminated and 85% for 1968 were eliminated, Petitioner would still have shown no profit from its Wisconsin marketing business.

The overreach implications speak for themselves, and once again the Kansas City Star case, supra, provides the legal impact -- allocated expenses can and must be taken into account in the process of determining the Wisconsin taxable income of a multistate enterprise.

(5) Wehner's Expert Testimony:

The unequivocal and unchallenged testimony of Wehner places the whole record in sharp perspective:

(a) There was excellent integrity in Petitioner's transfer prices from Exploration and Production to Refining and from Refining to Marketing; the income for the Marketing function as a whole was accurately identified, as was that from the Wisconsin marketing operations, in that Wisconsin sales and

cost of sales were properly determined by Petitioner and its allocable expenses were predicated on proper allocation methods; and, therefore, Petitioner's separate accounting returns properly reflected the results of its Wisconsin operations (Tr. Vol. Vi, pp. 101-105).

(b) The Wisconsin marketing operations in no way contributed to Petitioner's Exploration and Production income, for the latter was earned at its source, yet Respondent's use of the apportionment formula had the effect of taxing a portion thereof (Tr. Vol. V, pp. 106, 107).

(c) The weighting of the cost of manufacturing ratio produced a distorted result (Tr. Vol. V, pp. 107, 108).

(d) The employment of an apportionment formula in this case could not have produced a reliable and reasonable result, but, to the contrary, it produced a grossly inequitable result completely out of proportion to Petitioner's activities in Wisconsin, as evidenced by Exhibits 28, 29 and 30 (Tr. Vol. V, pp. 111-115, 119, 120).

Significantly, Respondent made no effort on cross-examination to challenge or modify any of the foregoing conclusions.

APPENDIX III

Proposed Findings of Fact

[Note: Because the jurisdictional and background facts are covered by the Stipulation, Exhibit 15, they are not again set forth here.]

1. During the first audit of Petitioner, Respondent did not make a factual determination as to whether or not Petitioner was a unitary business.

2. During the first audit of Petitioner, Respondent did not make a factual determination as to whether or not Petitioner's Wisconsin operations were an integral part of a unitary business.

3. During the second audit of Petitioner, Respondent did not make a factual determination as to whether or not Petitioner was a unitary business.

4. During the second audit of Petitioner, Respondent did not make a factual determination as to whether or not Petitioner's Wisconsin operations were an integral part of a unitary business.

5. The figures in Petitioner's separate accounting returns for the years 1965 - 1968 are valid and correct based upon Petitioner's books and records and upon proper internal accounting principles consistently applied.

6. Petitioner's three main departments, Exploration and Production, Refining, and Marketing, were organized and operated as separate segments and separate functional operations of Petitioner's total corporate enterprise.

7. Petitioner utilized internal transfer prices between its functional departments that were the equivalent of third party competitive prices.

8. Income derived from each of Petitioner's functional operating departments could be determined from Petitioner's books and records.

9. Petitioner's three main functional operating departments, Exploration and Production, Refining, and Marketing, were each unitary businesses.

10. Petitioner's Exploration and Production and Refining departments for the years 1965 - 1968 had no operations or activities in the State of Wisconsin.

11. Petitioner's Marketing Department did conduct business in Wisconsin in the years 1965 - 1968.

12. Petitioner's marketing operations in Wisconsin were not an integral part of Petitioner's Exploration and Production function.

13. There was no economic dependence between Petitioner's Wisconsin operations and its Exploration and Production function.

14. Petitioner's Wisconsin operations could be severed without affecting the economic viability of its Exploration and Production function.

15. Petitioner's marketing operations in Wisconsin were not an integral part of Petitioner's Refining function.

16. There was no economic dependence between Petitioner's Wisconsin operations and its Refining function.

17. Petitioner's Wisconsin operations could be severed without affecting the economic viability of its Refining function.

18. Petitioner's Wisconsin operations were not an integral part of Petitioner's Marketing function.

19. Petitioner considered Wisconsin during the years in issue to be an expansion marketing area, and its operating results in expansion areas were substantially less favorable than in mature marketing areas.

20. Petitioner's Marketing Department's overall net income as a percentage of sales was 3.2%, while the Respondent's assessment here in issue attributed a net income of 7.5% to Petitioner's Wisconsin sales; and the assessment also shows a distortion in the comparison of Wisconsin factor attributes of each functional department to the percentage of income produced by each function.

21. The assessment by Respondent imposed a tax on Exploration and Production and on Refining net income of the

Petitioner, which was derived solely from operations outside the state and which had no integral relationship with Petitioner's Wisconsin marketing operations.

22. Wisconsin taxation of net income from Petitioner's Exploration and Production and its Refining functions subjects Petitioner to multiple state taxation as to such income.

23. The apportionment formula used by the Respondent as to the assessment in issue utilized a calculation method differing from the statutory format of Section 71.07, with no published rules or regulations prescribed to explain it; and such formula also utilized certain assumptions such as uniform return per dollar of sales, which are contrary to the facts of the Petitioner's operations.

United States Senate

COMMITTEE ON THE JUDICIARY
SUBCOMMITTEE ON ANTITRUST AND MONOPOLY
(PURSUANT TO SEC. 4, S. RES. 72, 94TH CONGRESS)
WASHINGTON, D.C. 20510

December 5, 1975

Mr. J. K. Jamieson
Chief Executive Officer
Exxon Corporation
1251 Avenue of the Americas
New York, New York 10020

Dear Mr. Jamieson:

The Antitrust and Monopoly Subcommittee of the Senate Judiciary Committee is holding hearings on various vertical divestiture bills designed to prohibit the major oil companies from participating in more than one of the four principal phases of the petroleum industry. Among the questions raised by the proposed divestiture legislation is the practicality of restructuring the industry. Consequently, the Subcommittee is examining the feasibility of:

(a) maintaining the smooth functioning of the petroleum industry as reorganization takes place; and

(b) protecting the rights of creditors, stockholders, and bondholders of companies to be affected by divestiture.

To pursue a further, detailed study of these issues, I request that you, within the next week, provide the Subcommittee with the following information:

(1) a copy of your Certificate of Incorporation, as amended to date.

(2) a copy of your By-Laws, as amended to date.

(3) audited, abridged, financial statements for your past three fiscal years.

(4) audited consolidating and consolidated financial statements for the past three years.

(5) profit and loss statements and balance sheets audited, or unaudited, covering separately production, transmission, refineries, and marketing.

United States Senate

COMMITTEE ON THE JUDICIARY
SUBCOMMITTEE ON ANTITRUST AND MONOPOLY
(PURSUANT TO SEC. 4, S. RES. 72, 94TH CONGRESS)
WASHINGTON, D.C. 20510

Mr. J. K. Jamieson Page 2.

(6) cash flows for your corporation on a consolidating basis for the past two years and a projection for next year.

(7) a copy of each type of bond, debenture, or note now outstanding as well as each debenture, bond, or note agreement now outstanding, together will the related prospectuses for each such security, all of the above as amended to date.

(8) a copy of your last two proxy solicitations addressed to common and/or preferred shareholders.

(9) to the extent not already called for by any of the provisions hereinafter set forth, all registration statements, prospectuses, and proxy solicitation materials filed by you with the Securities and Exchange Commission during the past three years.

The information listed above should shed some light on the very important questions posed at the outset of this letter. I appreciate your cooperation in supplying these materials. They will aid the Subcommittee in carefully assessing the proposed divestiture measures.

Sincerely,

Philip A. Hart
Chairman

CEB/lct

December 16, 1975

Honorable Senator Philip A. Hart, Chairman
Sub-committee on Anti-Trust and Monopoly
United States Senate
Washington, D. C. 20510

Dear Senator Hart:

This letter is in response to your letter of December 5, 1975 addressed to Mr. Jamieson.

There is attached a separate summary listing the items which we are providing in response to your request. Where necessary, explanations of the attached items also are included in the summary listing. As background to this information, we invite your attention to Exxon's earlier statement to your Sub-Committee. A copy of this presentation dated November 12, 1975 is attached for your convenience.

Our response to Item 5 in your list of questions provides information on investment, revenue, costs and profits by segments of our combined operations which were derived on a reasonable basis considering the indicated assumptions. Since this information has not been made public, we specifically request that it be given confidential treatment.

In connection with Item 6, we have included a copy of the Exxon News dated December, 1975 which was sent to all shareholders. The last page highlights the financial and operating results for the third quarter and the first nine months. Earnings for both periods of 1975 relative to 1974 are down more than 25%. Operating volumes are down by smaller percentages. Reasons for these declines are contained in the pamphlet. At the same time that earnings are being forced down, capital and exploration expenditures have increased - up 26% even though no amounts are included for Venezuela for 1975.

By means of previous correspondence and testimony before your Sub-committee, Exxon Corporation has stated its reasons for objecting to various Congressional proposals to divide the major oil companies into several separate units. We believe that the enactment of such legislation would have far reaching and detrimental impact on both the nation's economy and on consumers of energy. Uncertainty in the investment community and interruption of ongoing energy investments would be immediate consequences. The interests of creditors, stockholders and bondholders would be drastically affected. In the long run,

divestiture would cloud prospects for energy development, it would deprive consumers of the efficiencies of integrated operations, and it would lead to even greater dependence on high cost imported oil.

For the above reasons, we believe it is essential that adequate time and effort be spent to inform Congress of the full implications of divestiture. We hope that the data which we are submitting will contribute to that end.

Very truly yours,

United States Senate
COMMITTEE ON THE JUDICIARY
SUBCOMMITTEE ON ANTITRUST AND MONOPOLY
(PURSUANT TO SEC. 4, S. RES. 72, 94TH CONGRESS)
WASHINGTON, D.C. 20510

December 18, 1975

Mr. A. L. Monroe
Controller
Exxon Corporation
1251 Avenue of the Americas
New York, New York 10020

Dear Mr. Monroe:

Thank you for your December 16, 1975 submission in response to my letter of December 5, 1975.

In reviewing the items which you have provided, I note that you did not submit "audited consolidating ... financial statements." The information included in SEC Form 10-K and the company's Annual Report does not include such a statement or information that would allow construction of such a statement. I would ask that if you do prepare unaudited consolidating financial statements for the parent corporation, its subsidiaries, affiliates and related companies, would you please forward those to me for the years 1973, 1974 and 1975. If you do not prepare consolidating financial statements but they are prepared by your auditors in their preparation of a consolidated financial statement, would you please advise me accordingly and request your auditors to forward that information to me.

Also, I note that you did not submit profit and loss statements and balance sheets covering "separately production, transmission, refineries, and marketing." Your item 5, while of some assistance, does not include, nor permit construction of the information sought in the December 5 letter. It would seem that you would have available an asset statement for each of those four separate areas even if you are unable to ascribe liabilities or debt with specificity to those individual asset groupings. If you do have asset information shown in that fashion, would you please forward it to me.

If you have available or if your auditors prepare statements of revenue and expenditure directly attributable to each of the above asset groupings with such allocation of revenue and expenditure as you or your auditors may make, please forward that to me for the years 1973, 1974 and 1975.

Lastly, may I request that you forward to me your auditors' retention letter and your auditors' internal control letter together with a copy of the most recent meeting of the board of directors at which the auditors' report was the subject of board discussion. I would request this information for the same three years.

Your continued cooperation is appreciated.

Sincerely,

Philip A. Hart
Chairman

HB/lct

A. L. MONROE
Controller

January 6, 1976

Honorable Senator Philip A. Hart, Chairman
Sub-Committee on Anti-Trust and Monopoly
United States Senate
Washington, D. C. 20510

Dear Senator Hart:

Your letter of December 18, 1975, requested further clarification of the material provided by us in response to your letter of December 5, 1975. As we indicated in our first response and as further discussed with a member of your staff, Exxon Corporation's financial records are not maintained on a functional or segment basis similar to those categories set forth in your item 5.

Consolidating financial statements in the format you desire are not prepared by Exxon Corporation or by our independent public accountants. Exxon Corporation's consolidated financial statements are prepared from a series of corporate financial statements representing regions, divisions, or affiliates. These entities are basically established by geographical and political boundaries rather than by the functional operations described in your request.

Pursuant to your request for additional data on the four functional areas, we are submitting the gross and net property, plant and equipment, segregated as shown in the Attachment. This material was previously aggregated for submission to another Congressional Committee and the footnotes, definitions and exclusions are a significant part of the numerical information and should be considered a vital part of any utilization of such data.

As for further statements of revenue and expenditure data directly attributable to each of the above-mentioned groupings, our earlier response, together with the above clarifications, indicate that our corporate records are not maintained in that manner nor do our independent public accountants prepare such allocations. As we indicated in our December 16 response and in responses to other Congressional committees, to the FTC's Line of Business and Corporate Patterns reports, and to the FASB's proposal for segment reporting, the petroleum business is unitary in nature. The most meaningful segmentation of our operations is the "upstream"/"downstream" segmentation previously furnished for the years 1972-1974. Further breakdowns require many allocations and assumptions, which could lead to erroneous comparisons of data between various companies and hence erroneous conclusions. Data for 1975 will not be available until March 30, 1976.

We are attaching copies of our auditors' (Price Waterhouse & Co.) retention letters for the years 1972-1974. Our auditors do not prepare financial statements for segments of our operations.

Very truly yours,

G. Maniro